

THE FUNCTION OF MONETARY CONTROLS

Address by
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In an article in last Sunday's St. Louis Post-Dispatch, Raymond P. Brandt, the chief of its Washington Bureau, wrote:

"Only two major issues will confront the new Congress . . . Restraining Communist aggression abroad and controlling inflation at home . . . All other issues are minor."

I am to talk to you tonight about one of those two major issues - controlling inflation. I approach this task with mixed feelings - on the one hand with a strong sense of the importance, the urgency, of the subject; on the other hand with a sense of inadequacy. Over the past decade we have heard a lot of talk about inflation and its control. About everything that could be said on the subject has been said many times over.

We have been reared to think of a peaceful world as normal, although it actually has not been peaceful in our adult lifetime. Now we realize that we aren't going to see what we thought of as "normal" times for the rest of our lives, or while Stalin's ruthless dictatorship controls a large share of the world's resources, with satellite armies ready to march when he pulls the string, just as they did in Korea.

The implications are clear. We are going to devote a large share of our national resources to building and maintaining here and in Europe, if there is time, a great military force. The renewed military effort must be superimposed on an economy that was already going nearly full blast with comparatively few unemployed last June. That's vastly different from 1940 when we had ten million unemployed, and a lot of slack in our production line. The actual effects of the expenditures and material drains involved in this program haven't been felt yet, but their anticipation has given us a foretaste.

To my way of thinking, one of the most significant aspects of this foretaste is that it has occurred before there has been any large-scale impact from our renewed military and foreign arms aid program. The inflationary kick from this factor is still largely in the future. So, too, is the return to deficit financing on a large scale which I am morally certain is ahead of us.

We've had more than a nodding acquaintance with inflation over the past ten years but there is still a lot of fuzzy thinking about it and its root causes. Inflation is an old economic disease which has one very curious characteristic. Most of us like some aspects of it. All of us like to see inflated prices on what we sell, though none of us likes inflation in what we buy. Everyone has a sort of a split personality when it comes to controls for inflation. We are apt to favor controls for the other fellow, and freedom for ourselves.

We have inflation when the rate of flow of spending exceeds the rate of flow of goods and services into the market. Now that is not a hard idea to grasp and yet a good many of the prescriptions for inflation tend to ignore its basic cause, which is, I repeat, a disproportionate increase in the volume of purchasing power relative to available goods and services.

War, or intense preparation for war, gives a doublebarreled impulse to inflation. It steps up demand for labor, materials and facilities, while it subtracts them from the use and service of civilians at the same time civilian incomes are expanding. I know that the National Industrial Conference Board has nice figures to show that inflation hasn't increased much since June 25th, but brothers, we haven't seen anything yet to what we will see if (1) military spending is as large as projected, and (2) if we don't do better than we have been doing to finance the government deficit in other ways than through commercial bank and central bank credit.

paint in a couple of details. Most purchasing power comes from current income, but there are two important ways to augment it - by the use of past saving for current spending, which means a more rapid turnover of existing purchasing power, and by drawing against future income, that is, by credit expansion. These two factors widen the disparity between the flow of purchasing power and the flow of goods and services into the economy, and put more dynamite into the inflationary kick.

Let's say that purchasing power is the money supply times its velocity. If we slow down the rate of spending we reduce applied purchasing power. If we sop up some of the increased income through taxes or through savings, we attack inflation at its source. So do we also, when we restrain growth in credit or perhaps even reduce the amount outstanding. Let me stress again that the only real cure for an inflationary situation is to bring the supply of purchasing power into balance with the supply of goods and services. No other method cures the disease.

That is the inflationary process, as simply as I can put it. It can be attacked on two sides - either the rate of flow of civilian goods and services can be increased or the rate of growth of purchasing power can be restrained. That's the case in theory. Actually the attack has to be made on the money supply. When an inflation becomes dangerous, the economy generally is producing at pretty close to capacity. That's the case now. Obviously it is in the national interest to keep production for civilian use rolling up to the limits fixed by the needs of the military program. But a broad increase in available goods and services over a short period of time is hardly possible. To arm ourselves and our allies we have to take vast quantities of goods and services from civilian use. As far as consumers are concerned, we might just as well sink these goods in the ocean.

So if we are to restrain inflation when the armament impact hits us, we will have to act on the money supply - hold down increases in the flow of purchasing power as well as we can to balance the supply of available goods and services.

There are several avenues of attack on the money side. I will mention just a few: voluntary self-restraint; reduction of non-military spending; taxation to meet military costs as nearly as possible on a pay-as-you-go basis; greater savings; and a restrictive monetary policy. I'll have the most to say about the last.

These are primary steps, aimed at the causes of inflation. You may wonder why I haven't listed price and wage controls across the board in this category. Price and wage controls by themselves do not stop inflation. They may conceal and defer the effects of inflation, but sooner or later if the fundamental causes of inflation are not dealt with, there will be an explosion. A tied-down safety valve on a boiler won't hold the steam in check very long if you keep shoveling fuel into the fire box.

Prospects are dim that inflation can be overcome by voluntary action, although general restraint - a willingness to discipline ourselves - is essential to any successful program. The reason why individual, voluntary restraints historically have not sufficed lies in that curious split personality of individuals and businesses with respect to inflation. The things each individual, each business, each labor or farm group, each banker and each Government official must do to overcome inflation through a program of voluntary restraint run counter to habitual action and preferences. But to the extent voluntary restraint can be exercised, it is extremely helpful.

Unnecessary spending must be restrained not only by individuals and businesses but also by Government - Federal, state and local. In the present situation any decrease in the volume of spending must take place mainly in the non-

military sector of the economy. Government can do much more than it shows signs of doing to curtail non-essential expenditures to offset increased military costs. To the extent it succeeds, inflationary pressures will be reduced. The difficulty in government retrenchment, of course, stems from the fact that people and their political leaders really don't want it applied to their own pet projects or interests.

A more promising avenue of attack is through increased taxes. If we can pay as we go with increased taxes to match the added armament costs we could conceivably sop up an amount of purchasing power equivalent to the amount of goods that will be taken away from civilians for defense purposes.

The main sources of additional tax revenue may all be employed - taxes on individual incomes, corporate profits, excess profits and excise taxes. These taxes have different effects on spending and investing, and it is important to look at them not only as revenue sources, but also from the point of view of their general effect on the economy. Today's program touched on some of these considerations, and I do not have time to go into them.

A fourth avenue of attack is through encouragement of savings. A successful program of selling government securities to non-bank investors increases savings, reduces private spending, and lets Government spend borrowed funds without swelling the money supply. Appropriate debt management policy will lead the government, when it needs to borrow new money, to get all it can from non-bank sources. And when it has to refund maturing issues, the object should be to lodge more securities outside the banking system, because it is borrowing from the banks that increases the money supply.

A restrictive monetary policy, the last of the avenues of attack I mentioned, is a powerful force that can be brought to bear on the money supply. It is harder to understand, and I will talk about it most. Teamed with a complementary

policy of debt management and a strong tax program, restrictive monetary action attacks inflationary forces right at the source. An easy monetary policy may not, at times, be very effective in inducing economic revival, but there isn't much doubt that tight money can check a boom. When money becomes tighter, the spending plans of individuals and of businesses have to be modified downward.

A restrictive monetary policy operates through reducing availability and increasing cost of bank reserves, and is expressed through an increased cost of money; in other words, in higher interest rates. Restraint is used to make it more difficult and more costly for the banks to obtain reserve funds, which, under our system, are necessary to support a further expansion in their loans and investments.

Of course there are other and more direct restraints. Selective controls, such as are applied to stock market, installment, and new housing credits, are easily understood. But the function of bank reserves, the way the fractional reserve system works, and the relationship between bank reserves and the interest rate on the government debt are not generally understood, and since there will be wide discussion and controversy over them in the days ahead, I want to spend the rest of my time talking about them.

Everyone of the steps to enforce a restrictive money policy is painful and hard to take. Part of the responsibility in these steps belongs to the Federal Reserve system. The agency that tries to meet this responsibility can never be popular, but perhaps its policy can be understood, at least by intelligent groups like this. I'm not too sure of that, either, because the process by which bank credit expands and contracts, and the effect of such changes on the money supply are by no means simple to explain or to understand. It's a whole lot easier just to cuss out the Federal Reserve and let it go at that. The problem of monetary

restraint is made more difficult because bankers, with whom you ordinarily will discuss it, while they would like to have higher interest rates, oppose any move to restrict their ready access to lendable reserves or their freedom to expand bank credit wherever there is a demand.

Banks in the United States are required to hold certain percentages of their deposits as reserves, mainly with the Federal Reserve Banks. When the banking system acquires excess reserves it can expand its loans and investments about six times the amount of the new reserves. If that happens, it adds about that much to the country's money supply. Don't ask me to explain how the fractional reserve system works, for there isn't time. Just take my word for it.

If the banks want to continue to expand their loans, they must have new reserve funds. There are two main ways to get them - from an inflow of gold, and from the central bank, which in this country of course is the Federal Reserve. Disregard the gold movement as relatively unimportant at the moment. The banks can get Federal Reserve funds in two ways - by borrowing from, and by selling government securities to, the Federal Reserve Banks.

The Reserve Banks can exercise restraint in their loans to member banks through the discount rate and in other ways. But restraint through refusing to buy government securities offered in the market is more difficult to accomplish. It is most important to recognize that the Reserve System is not free to reduce the availability of reserves and of bank credit as long as it is required to hold a rigid pattern of rates on Government securities. Holding a rigid pattern means, of course, that the System has to buy securities at any time they are offered in surplus on the market to prevent a decline in price and an increase in yields. It is an absolute guarantee of complete availability of reserves at all times; banks

have automatic access to Federal Reserve funds and at terms that generally yield them a book profit on the securities they sell.

Action by the Federal Reserve System to make reserves harder for the banks to get reduces the basis for bank credit expansion, and is appropriate action under inflationary conditions. Right here I want to make a most important point that is not appreciated very widely. The operations of the Federal Reserve System in tightening reserves of commercial banks result in an upward movement of interest rates. We recognize fully that these upward movements in rates do not do much to restrain borrowers. The cost of credit, in other words, is not a major factor as far as borrowers are concerned. And the main restraint on lenders does not rest so much on the cost of credit as it does on these other factors: Rate changes increase bankers' need for liquidity because of uncertainty as to whether additional reserves will be available and at what cost; rising rates reduce the market price of assets on hand and thus make their sale less attractive; and finally, higher rates on government securities make them more attractive, thus dampening enthusiasm for other loans and investments.

You all have heard statements to the effect that the Federal Reserve System thinks it can keep people from borrowing by raising interest rates a fraction of 1 per cent. That is a complete misinterpretation of the System position. The rise in rates may have no effect whatsoever on the demand for credit, but it does reduce the availability of credit and that is exactly what the present and prospective situation seems to call for.

I want to make one more point as clear as I can. Rising interest rates, which reflect lessened availability of credit, operate both on the private and public sectors of the money market; in other words, rate increases apply to Government securities as well as to private securities and private loans. But the question of cost involved in higher rates on Government securities should be put in proper perspective. An increase in the interest rate increases the cost to the government of carrying the public debt. That is part of the price to regain control over the rate of expansion of bank credit. The Federal Reserve believes that this increased cost, which would be counted in millions, should be weighed against the total cost to the government and the public involved in further inflation, which would be counted in billions paid in increased prices for each percentage point the price level goes up. And, finally, any program that tends to restore confidence in the dollar's purchasing power, even though it involves higher interest payments on part of the debt, would produce a stronger and more stable demand and market for Government securities of all types.

Concern over the cost of servicing the vast public debt is easy to understand and explain. But the issue is by no means one-sided, and should be weighed calmly, openly, and as objectively and good-naturedly as possible.

The Federal Reserve on August 18 said it is prepared to use all the means at its command to restrain further expansion of bank credit consistent with its responsibility to maintain orderly conditions in the government securities market. If it does that, it is in for a lot of criticism and opposition. It isn't a simple, easy problem we face, but then the task of preserving a reasonably stable economy without surrendering all our individual decisions to government control isn't an easy one at any stage and particularly so in times like these.

There is a relationship that is in danger of being overlooked between the program of general monetary restriction I have been discussing and the preservation of individual choice and freedom. General controls leave freedom of business

choice and decision to the individual; direct controls such as price-and-wage-fixing, rationing and allocation of supplies do not.

There is an increasing demand for price and wage fixing, for a more and more controlled economy. It comes from all segments of the American people - from businessmen individually and in organizations, from labor unions, from the press, from housewives, from all types and kinds of individuals. It is ironic exaggeration, perhaps, to observe that the so-called economic planners at present constitute the main vocal group now speaking against all-out direct controls, and in favor of a general anti-inflation program that will tend to preserve individual freedom.

The important variable between our system and others is the individual's freedom of opportunity and choice. The core of that freedom and choice is the relatively free movement of prices which impersonally and efficiently direct labor, land and capital into economic uses. Our economic system is flexible and dynamic primarily because we use the price mechanism to allocate resources.

A good many people who press for more direct controls believe that these by themselves will cure inflation. Nothing could be further from the truth. True, they tend to suppress inflation and push its effects off into the future. There may come a time for direct controls, and it will be hastened if we fail to act courageously and in harmonious teamwork to carry out general restrictive measures. Total mobilization of the nation's resources, if it comes, will undoubtedly bring government controls straight across the board. Even then, to work, they will have to be backed up by strongly restrictive fiscal and monetary policies.

Now I'll let you come up for air. What I have talked about is just one of the skirmish lines in a world-wide front. The questions that confront us are many and immensely complicated, and no one has all the answers. No one can now prescribe in full the course we should follow. Yet we must face the future with

freedom and the dignity of individual man will survive and we must be willing to fight to make that come true. In that spirit lies the hope that today's pain and struggle may be made only a phase in the evolution of a safer and better world - one in which freedom of thought and the institutions of human freedom have survived.