

MONETARY POLICY AND NATIONAL DEFENSE

Address by  
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One of the most pleasant experiences an alumnus of a University or College can have is to be asked to return to the campus of his student days. Such an invitation is not only pleasurable but stimulating. Though I have been in Columbia a good many times since graduation from the Law School of this University, this is one of the few times I have come back as a participant in a regular campus activity. I am delighted to be here for Business Week and am grateful for your invitation.

My topic today is "Monetary Policy and National Defense". It seems to me that few subjects are of more timely importance than this one. Appropriate or good monetary policy can make a major contribution to the success of our defense program. Inappropriate or bad monetary policy can be a major roadblock on the way to attainment of our goals in the defense period.

Right at this point let me make one thing clear. I do not mean to imply that monetary policy is the only important factor in a successful defense effort. Production policy, wage and price policy, fiscal and debt management policy, to mention but a few others, are vital factors in a complete program. Monetary policy is important, and I would not under-emphasize it, but we must recognize that it is just one of many phases of an effective defense program. An engine must have all of its working parts and be supplied with power if it is to run efficiently and smoothly. No single part can be said to be the only important one. Neither is the power supply the exclusively important factor. But when one piston is inadequate or fails to do its job, or when the power is inadequate, the engine, if it runs at all, limps along at less than optimum performance. If the power supply fails entirely, the engine simply does not operate.

Let me carry the analogy further. The national economy may be viewed as an engine which uses money and credit as its power supply or fuel. The supply of fuel should flow into the engine in such volume as to keep it operating at full efficiency. If it is either more or less than needed, the engine falters. In economic terms, too little fuel means deflation; too much means inflation. When the rate of flow of spending in the economy exceeds the rate of flow of goods and services into the market, we have the basis for inflation. When the imbalance is the other way, we have the basis for deflation. The primary role of monetary policy is to see, insofar as monetary policy can, that the relationship between money and goods stays in decent balance.

That is not a very difficult idea to grasp, but I am always surprised to discover how few people seem to grasp it. Perhaps I should not be so surprised, for I suspect that actually the idea can be and is comprehended. What seems to be lack of comprehension is often, I believe, mostly distaste for the actions that should be taken to correct imbalance. In any case, I am sure that practically all of you, as Business School students, have become acquainted, in your economics and money and banking textbooks, and in your classes, with the concept I have tried to state and illustrate.

Throughout this talk the kind of imbalance I shall speak about is an inflationary imbalance, and the monetary policy I shall outline has to do with correcting an inflationary imbalance. I am doing this because the basic problem at this time is inflation rather than deflation. In other words, today the money-goods relationship is out of balance - and on the side of too much money. I want you to remember, however, that we have the reverse type of problem; we did have it throughout most of the 1930's. It is the objective of monetary policy to operate as a corrective

factor in either inflation or deflation.

Let us look for a moment at the fundamentals of today's problem. Take the money side first, the purchasing power side. Most purchasing power comes from current income, but there are two important ways to augment it: first, by using past saving for current spending, which means a more rapid turnover of existing purchasing power; and, second, by drawing against future income, that is to say by credit expansion.

On the goods side we have all goods and services produced currently plus existing stocks. Current production of goods and services generates current income. In a period like the present we have a certain proportion of the currently produced goods being removed from the market for defense purposes. But the current income generated by production of those goods remains. So, a gap is created between current purchasing power and current production of goods, and that gap is widened by the use of past saving and by the expansion of credit. Such a situation is the basis for inflation. The money-goods relationship has got out of balance.

Theoretically, we could restore the balance by working on either side. We could try to increase output, or we could try to reduce purchasing power. Practically, we have to work mostly on the money side. In an inflationary period the economy usually is operating fairly close to capacity, which means that over the shortrun it is extremely difficult to increase output very much. At this particular time we know that defense demand is going to increase. Probably the volume of goods and services available for civilian use will decline rather than increase in the immediate future. That leaves the approach to the money side as the practical approach.

The two major avenues of access to the money side are through fiscal policy and monetary policy. In a situation like the present both can operate effectively to restrict spending, fiscal policy by taxing away the differential between current civilian income and current civilian supply of goods, monetary policy by restricting growth in the money supply itself. It is the latter phase which I want to discuss more fully.

Before going into this point I want to be sure that I make clear the importance of a proper adjustment between money and goods at any time, and the particular importance of it at this time. A moment ago I drew an analogy between the economy and an engine. The basic reason for keeping the economic engine in balance is that it operates most efficiently that way. Either inflation or deflation brings about less efficient operation. What happens when the money-goods balance is broken goes something like this: first, rapid changes in prices with considerable variation in those changes as far as different items or goods are concerned; then accompanying rapid changes in both real and money incomes; then changes in demand-supply relationships and variations from previous patterns of such relationships. All of these contribute toward increasing distortions in the economy and consequent loss of efficiency.

In a period like the present, the imbalance, as I have said, is on the inflationary side. The distortions just referred to have appeared and are appearing, and the efficiency of our economic engine is impaired. As the staff of the Joint Committee on the Economic Report recently put it, "Inflation corrodes production incentives, makes 'suckers' of savers, inflicts arbitrary hardships on those receiving fixed incomes and generates the kind of social injustice and social unrest in which the propaganda of communism is most successful".

This would be bad enough if the problem were purely domestic. But at present we face an international emergency. We have to keep operating efficiently in order to survive. The importance of a stable economy is far greater now than it would be in a period of relative international quiet.

Inflation not only impairs the efficiency with which we operate at a critical time; it increases the cost of our whole defense production effort. Prices of goods used for rearming have gone up tremendously. All of you have read reports about the steadily shrinking purchasing power of the defense dollar. The Joint Committee report released a few days ago pointed out that galloping inflation has knocked a lot of military airplanes out of the sky just as surely as enemy antiaircraft fire might have done.

Let me drive home the importance of economic stabilization with two more brief references. Speaking in the Senate earlier this year, Senator Paul Douglas of Illinois stated that, "Next to the questions of foreign policy and defense, the threat of inflation is perhaps the most serious problem we have".

And in Defense Mobilization Chief Wilson's recent quarterly report to the President it is stated that the production side of the defense task is in many ways less difficult than the stabilization side. As Mr. Wilson states it, "A tougher test of our ability to survive the present crisis lies in the other side of the problem - stabilization. If we let it, inflation can sap the strength of the economy and in fact threaten the success of the whole defense effort."

One final point should be noted about the symptoms and consequences of inflation. Not the least of the problems brought about by inflationary distortions in the economy are the problems of correction

and repair after the economic engine breaks down. Usually it takes some time to solve these problems, and meanwhile a lot of people get hurt. For the aftermath of inflation is deflation, often severe depression. You might call the inflationary process the imbibing stage, the deflationary process the hangover stage. The hangover stage is reputed to be painful; but apparently too few people realize that the best way to avoid a hangover is to refrain from drinking the stuff that causes it.

In passing I might mention that the economic signposts point to inflation now and for the immediate future while the defense program continues to grow. It may well be that we are storing up some headaches for ourselves that will begin to hurt sooner than we think. The sharp increases that have occurred in certain kinds of inventory, largely financed with credit, could cause trouble. If it were not for the scheduled size and duration of the defense program there might be trouble quite close at hand.

But now let me get back to my main thesis, the role of monetary policy in combating inflation and in the adjustment of the money-goods balance. Again I want to stress the fact that monetary policy alone is no cure-all for inflation and that fiscal policy, especially a tax program that siphons off dollars before business and consumers have a chance to spend them, also is a key factor. Any program that aims at reducing spending and increasing saving helps reduce inflationary pressures. But the monetary field happens to be the field I am in and I want to discuss it.

It should be helpful at this point to bring out a few essential facts about the monetary system and the way it works. You might call

this a capsule refresher course in money and banking. Most of you will recall these facts as I give them, and I shall not explain them in any detail.

- (1) The money supply is the sum of currency outstanding and bank deposits, both demand and time. The bulk of the money supply is bank demand deposits - checkbook money.
- (2) Purchasing power is the money supply times its turnover rate or velocity.
- (3) The commercial banking system can create deposits by expanding its loans and investments. In other words, the commercial banking system can, and does, create money.
- (4) In the United States most banks are required to maintain certain legal reserves, that is, to hold certain percentages of their deposits as reserves, mainly with the Federal Reserve Banks.
- (5) In order to expand loans and investments, and hence deposits, the banking system must have excess reserves, that is to say, reserves in excess of those legally required to be kept. When it acquires excess reserves, under present requirements, the banking system can expand its loans and investments about six times the amount of such reserves. This tends to add about that much to the country's money supply.

- (6) The commercial banks get new reserves from two main sources - from gold inflow and from the Federal Reserve, the central banking system of the United States. At the moment the gold movement is outward, and as a result the main source of reserves is the Federal Reserve.
- (7) Commercial banks get reserves from the Federal Reserve in two ways; by borrowing from, and by selling Government securities to, the Federal Reserve Banks.
- (8) The basic responsibility of the Federal Reserve System is to regulate the supply, cost and availability of bank reserves with a view toward maintaining full employment, stable values and a rising standard of living.

These eight propositions are the working basis for monetary policy. Note three of these key points again. (1) The commercial banks have to maintain certain legal reserves so that their deposit expansion is limited to a multiple of the legal reserve ratio. (2) The total volume of reserves can be increased or decreased by Federal Reserve action. (3) Federal Reserve action to increase or decrease bank reserves should be taken with a view to maintaining stable values and an expanding economy.

Given an inflationary situation where the money-goods relationship is out of balance with too much money, a restrictive monetary policy is a powerful force that can be brought to bear on the problem. It attacks inflationary forces right at the source. Tight money can check a boom; it does so by causing the spending plans of individuals and

businesses to be revised 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, through higher interest rates. The Federal Reserve Banks can exercise restraint in their loans to member banks through the discount rate and in other ways. They can exercise restraint in their open market operations by refusing to buy the Government securities offered in the market.

This latter point is most important, for it is the key to understanding of the widespread discussion of the role of the Federal Reserve System at the present time. When the Federal Reserve buys Government securities it adds to bank reserves. This is often referred to nowadays as "Monetization of the public debt". When the Federal Reserve sells securities, it contracts bank reserves, thus demonetizing, pro tanto, the public debt. If the System is to pursue a restrictive monetary policy it has to be in position to refuse to buy securities, and even to sell some. The Federal Reserve cannot be in that position if it has to maintain a fixed pattern of rates on Government securities.

Holding a fixed pattern means, of course, that the Reserve System has to buy securities at any time they are offered in surplus on the market. If we do not buy, prices go down and yields go up, which breaks the rate pattern. Therefore, Federal Reserve freedom to be restrictive in the money market means fluctuating Government security prices and yields, and not fixed prices and yields. It means that sometimes securities may be below par, sometimes they may be above par.

Here is another point that should have more widespread recognition. Restrictive action with respect to bank reserves leads to higher interest rates in the normal course of events. But higher interest

rates as such are not the aim of a restrictive policy; they are merely the reflection of a restrictive policy. The primary fact to remember is that the banking system cannot expand credit and deposits without excess reserves. Central banking restriction works by refusing to supply the reserves. Tightness in reserves brings about tightness in the money supply and, as the demand-supply situation of money tightens, interest rates tend to rise. The rise in interest rates, however, is only a by-product and not the direct objective of central bank action.

Another thing I want to emphasize is that Federal Reserve people do not believe higher interest rates have much effect by way of restraining borrowers. Higher rates do knock out a few marginal borrowers, but the bulk of borrowers are likely to continue their demands for credit even though the cost rises. In other words, in the case of most borrowers the cost of credit is a minor factor in relation to other costs.

Central bank restrictive action therefore is designed to be effective not on the borrower, but on the lender. By failing or refusing to supply reserves to the commercial banking system the central bank cuts down the availability of credit. As the central bank refrains from buying surplus offerings of Government securities, prices of such securities tend to fall and their yields to rise. As prices fall the prospective sellers become less enthusiastic about selling at a loss. So, lenders quit seeking to obtain reserves by selling securities. As yields go up, other lenders with excess reserves find securities more attractive and lose enthusiasm for loans as a medium of investment. Thus tightness is built up in the money market.

Now I want to make just one more point. You people have been studying business methods and the American economy. I hope you have

discovered one significant truth about the American economy: It is relatively free. We have and enjoy a high degree of individual freedom and choice . That very freedom of opportunity and choice is the important variable between our economic system and many others. These are not mere words nor idle sentiment. They describe the heart of the American system whose major reason for success is the fact that it is flexible and dynamic. It seems to me just good common sense to make every effort to preserve it.

As a means of combating economic imbalance, monetary policy, coupled with fiscal policy, sets some broad, general, and impersonal rules under which individual freedom and choice are preserved and the economy is left free to function flexibly and efficiently. The same cannot be said of certain harnesses of controls which invade the realm of individual freedom, limit individual choice, and introduce inflexibility and rigidity into the economy. Monetary policy, by reason of its very nature, helps preserve the kind of economic system we are used to and one that functions better than any other the world has ever seen.

We have a hard task before us. We have to meet our defense production goals; we cannot let the economy be weakened by inflation; and we must preserve the kind of economy we like and are accustomed to. If I have made any contribution to your deliberations during this Business Week of 1951, I hope it will be found in my attempt to cast some light upon this thesis: Monetary policy has a major role of great significance to play in our fight for the preservation of individual freedom and against that insidious thing known as "inflation", which has been called the "most subtle sixth column propelling capitalistic countries toward communism".