

COMPETITION FOR MONEY

**Address
by
Delos C. Johns
President, Federal Reserve Bank of St. Louis**

**Before a
Meeting of the
Federal Home Loan Bank of Des Moines
Des Moines, Iowa
Wednesday afternoon, April 24, 1957**

COMPETITION FOR MONEY

In recent months the expression "tight money" has been on many lips and much in the public print. As in the case of any phenomenon which affects the lives of millions of people, comment on it has run the gamut from approval to denunciation. Serving both as the excuse for failure to spend money and as the announced reason for spending more, tight money becomes either refuge or whipping boy, according to the needs or objectives of the orator. It is quite natural therefore that considerable effort should be expended upon efforts to fix responsibility for tight money. One widely held view, which passes facilely from mouth to mouth, is that the monetary authorities or the fiscal authorities of Government, or both, are responsible for conceiving the idea and bringing it to fruition. In this view the active role of the people in a free economy is strangely unrecognized. Therefore the role of the monetary and fiscal authorities is misconceived. Let it be perfectly clear at this point that the monetary authorities did have a part, and still do. But let us also make clear what that part was and is. This makes it necessary to relate some facts about the origin, growth, and intensification of a dramatic competition for money. For our purposes this afternoon the narrative may begin about five years ago.

At this time in the spring of 1953 we were witnessing the transition from a restrictive phase of monetary policy to one of monetary ease. Reflecting abatement of inflationary pressures which Federal Reserve policy had been resisting even before the famous accord of March 4, 1951, the longstanding

policy of restraint gave way to one which came to be known as a policy of "active ease", with the objective, as stated in the annual report of the Board of Governors, "to cushion defense and inventory readjustments and to foster business recovery and sustain economic growth." Throughout the balance of 1953 and all or most of 1954 the policy of "active ease" continued and was implemented by use of all three of the general monetary tools which the Federal Reserve System has at its disposal.

For a time the country enjoyed a period of prosperity and growth with stability, but eventually the symptoms of booming expansion began to be observable. Consumers made heavy use of credit in rapidly increasing their expenditures for houses and durable goods. In due course the weight of consumer demand was reinforced by a rapid acceleration of business expenditure for plant and equipment. This reflected not only response to the stimulus of consumer optimism and eagerness to spend, but also the necessity to offset rising costs by improving efficiency through elimination of technological obsolescence. The makings of a capital investment boom were unmistakably present. Interest rates rose; shortages began to appear in certain key commodities; and prices of an increasing number of commodities began to rise. These results were inevitable and therefore predictable.

The emergence of a capital investment boom necessarily meant that the demand for credit would be heavy. Unless the demand for credit were to be satisfied by monetary expansion, savings would need to increase substantially

or interest rates of necessity would rise. And it is a well known fact of economic life that business investment generates additional income and stimulates competition for goods and services for current use without enlarging the supplies of such end products in the short run. Thus it was clear that markets for goods and services, and the money and capital markets, would be under heavy demand pressure.

By the end of 1954 or shortly after it, Federal Reserve policy responded to these facts which indicated that the forces of inflation were again coming into the ascendancy, and it again became the System's objective to moderate the pace of credit expansion. Thus the wheel had come full turn. But this is not to say that the state of the economy was precisely as it had been when monetary policy was previously in a restrictive phase. The saying that "history repeats itself" must be taken with a large grain of salt by the practitioner of central banking, for each economic situation has its unique characteristics. What were the outstanding economic characteristics of the period in which the competition for money which is my subject gained the limelight?

In the first place, it was a period of high-level resource use. Employment was high; output in many lines was at or near capacity. Costs and prices were rising. Growth in the money supply was occurring at a moderate rate and the velocity or rate of use of money was increasing. Financial and nonfinancial corporations were less liquid than they had been. In this kind of setting a rise in interest rates is a sure indicator that the demand for funds for investment

is in excess of current savings. In the jargon of the market such an imbalance of supply and demand is described as tightness, and the resource in short supply is said to be "tight". Another way to put it is that there is competition for a scarce resource, and a part of the mechanics of competition in such a case results in bidding up the price. This result of the competition may not be expected to abate until equilibrium is restored by enhancement of the supply or reduction of the demand, or both. Thus it is a fact of the period under review that money could not cease to be tight until savings were either increased sufficiently to balance investment demands, or investment demands were reduced to balance with the availability of savings, or both.

Up to this point our analysis of the tight money period has omitted reference to the Federal Reserve System. In the presentation of the facts which I have just undertaken it has been my purpose to make it clear that out of these facts arose the problem which faced the Federal Reserve System. The decisions by savers and investors which resulted in an imbalance of supply and demand in the capital markets necessitated a determination of policy. Should the central bank supply the commercial banking system with reserves which would permit an expansion of bank credit with which to close the gap between savings and investment? What would be the result of following such a policy?

In considering these questions one must keep in mind the monetary tools which have been given to the Federal Reserve System. Through the power to vary reserve requirements and to conduct open market operations the System may at its own initiative add to or subtract from the reserves of the member

banks. Through the power to vary the discount rate it may affect the cost at which member banks, on their initiative, may obtain reserves at the discount windows of the Federal Reserve Banks. These are indirect, quantitative controls by which the supply of money in existence, its rate of change, and its cost may be influenced. The direct or selective control of the uses to which people may put their money is beyond the power of the Federal Reserve System at this time except in one case. The exception, as you know, is to be found in Regulations T and U of the Board of Governors with respect to so-called stock market credit. Having in mind the nature of the powers with which the Federal Reserve is armed, it will be apparent that if the System were to attempt to relieve the tight money situation, it would have to be done by bringing about an expansion of commercial bank credit. Would this really constitute relief? Obviously not.

The extra funds borrowed from commercial banks would add to the pressures already existing in markets for scarce commodities and services. This would add impetus to rises in prices, wages, and costs, threatening an inflationary spiral. The decision was taken, therefore, to resist these pressures. This is not to say that the supply of additional reserves to member banks was completely shut off. Some further reserves were made available, and to that extent the rise in interest rates was mitigated, though the underlying forces which caused interest rates to rise were not wholly offset. As a result commercial banks have been under restraint. Thus the role of the Federal Reserve in the tight money situation is a special one. If it had chosen to make reserves freely available to member banks the System could have permitted

the creation of enough credit to offset the deficiency in savings, but this it refused to do in view of its basic responsibility to defend the purchasing power of the dollar against erosion. Tight money, in other words, is the alternative to inflation and a cheap price to pay for defense against depreciation of the dollar.

How, then, do we explain the outcry against tight money and the insistent demand in some quarters that Federal Reserve policy be reversed or at least eased for certain special purposes? Partial answers may be given, I think, along two lines. There is a tendency in some minds to assume that tight money means that credit simply is not available at all. This you and I know to be false. You know, for example, that in 1956 home mortgage debt grew \$11 billion, a larger growth than in any other year except 1955; long-term corporate debt increased \$9 billion; consumer instalment debt rose \$2 1/2 billion; and new borrowings by State and local governments amounted to something more than \$5 1/4 billion. These figures must be taken as indicating vigorous growth of the economy as contrasted with a state of stagnation which some critics have been inclined to picture.

And yet we have evidence that some competitors for money have seen their demands unsatisfied and their contemplated expenditures postponed as a result. Complaints arise from some of these which excite sympathy in many reasonable minds. Are not home ownership and housing improvement desirable social goals? Are there not many public improvements such as schools and hospitals which sorely need to be provided? Are there not some

efficient small businessmen who find themselves at unfair disadvantage in a tight money situation as compared with business giants? What is monetary policy to do about this?

At the outset it should be understood that the monetary authorities in this country are practically powerless to discriminate between users or groups of users of the money supply in existence. I have already pointed out, but it is worth reiteration, that with one exception the Federal Reserve is armed only with indirect, quantitative controls. These are impersonal and nonselective in their application. All the System can do is affect the total volume of funds which the commercial banks can lend. Considering the aggregate of debt creation, only a small proportion of loans passes through the banking system. Financial intermediaries other than banks handle the great bulk of loans by which savings are made available for investment. The Federal Reserve's power to affect the amount by which the banks may augment savings is quite a different thing from, and falls far short of, the power to determine who may have access to available funds, either savings or new bank credit. The System has no means and no legal power by which it can make selective allocations of credit resources.

Saying that the Federal Reserve is powerless in this matter, however, does not answer the question whether the general monetary controls should be supplanted or at least supplemented by direct or selective controls. This leads to the question: Who makes the decisions, as things now are, concerning the uses to which the money supply of this country shall be put and who shall have access to it? In answering the question, one must take into account the flow of

spending that results from the production, distribution, and consumption of goods and services. One must take into account the savings of those who elect to save rather than spend. Since savings are generally spent, too, by borrowers who employ the savings of others, one must take into account the institution of credit in answering the question, "Who decides how the money supply shall be used?" And in considering the economic instrument called "credit" one must also be aware of the fact that in addition to the credit resources derived from savings another source of credit is to be found in the ability of the commercial banking system, if supplied with reserves, to create additions to the money supply by making loans. All these things considered, the answer may be truly made that the people of the country, operating in and through their political institutions, their private financial institutions, and their market places, decide how the money supply shall be used and how fast it shall be turned over in the stream of spending for consumption and investment. The people make these decisions, not the monetary authorities.

There are some people in the world who have no confidence in the ability of the people to make sound decisions with respect to the uses to which money shall be put, even in times of peace and normalcy, whatever that means. There are others who profess confidence in the people and in their institutions for deriving democratic judgments, such as free markets, but who are inclined to become so unhappy when they find themselves in the minority with respect to specific issues that they begin to clamor for the inauguration of governmental controls to prevent similar assumed miscarriages in the future. Whatever the cause or the motivation for raising it, a question which, in my judgment, will

have to be faced and decided in the future is whether the people shall continue to possess the prerogative of deciding in the main how their money supply shall be used or whether selective controls of money and credit shall be extensively added to existing general, quantitative controls.

This is a profound question involving fundamental issues of political as well as economic philosophy. Admitting that democratic institutions and processes do not always get the best answers, because these institutions are no less fallible than their human components, it would occur to me that the group judgments of the body politic, derived through the free market system, are more likely in the long run to be sound and acceptable than the decisions of a controller or group of controllers in Washington or elsewhere. In any case, we have achieved our present level and standard of living under a democratic, free market system, and as I look about the world at places where another kind of system has been or is employed, it does not strike me that reason for us to change is easily demonstrable.

Before concluding these remarks I think it is appropriate, and from my point of view it is important, to pay attention to an attitude concerning inflation which has gained some currency. That attitude has been given expression by voices which one of my most thoughtful Federal Reserve associates has aptly described as "urbane and persuasive", and it is to this effect: that a modicum of inflation, say, 2 per cent per year, may not be too bad and indeed may be inevitable if the economy is to prosper and grow. Every citizen of this country needs to ponder the matter and consider whether that is the kind of view we

desire to take of our future.

I take it that even the urbane and persuasive voices which willingly accept the idea of a "little inflation" or, as some say, "mild inflation", would be among the first to cry out against inflation of such astronomical proportions as we have observed in some other countries, most frequently during and in the wake of war. To those of us who were so placed as to observe at first hand the aftermath of such a catastrophe, as was my opportunity in the Kingdom of Greece seven years ago, the connotations of the word "inflation" are so forbidding that the idea of complaisantly accepting a little inflation every year and year after year is violently repulsive. I find no solace in such lulling adjectives as "little" or "mild" or "controlled" when applied to the noun "inflation". I reject the idea that there can be a controlled inflation limited to 2 per cent per year. If such a thing were publicly accepted as inevitable or as an objective of policy, the incentive to save would tend to disappear and the urge to spend would be sharply increased. Thus inflationary pressures would mount and with their well known proclivity to feed upon themselves would strongly militate against any possibility that the inflation could be controlled within such narrow limits. I repeat that there is no such thing as a deliberate, controlled inflation limited to 2 per cent per year.

Let us examine also the question whether an inflation of 2 per cent a year, if it could be controlled to that extent, would be "little" or "mild". Does it not occur to you at once that erosion of the purchasing power of the dollar at that rate would cut the real value of our monetary unit in half in 25 years -

in the time space of a generation? Does it not occur to you that a worker retiring at age 65 on a pension of \$100 per month would have the equivalent of about \$82 a month at age 75 and about \$67 if he should live to age 85? Aside from the element of personal tragedy which this would involve in individual cases, the economic, social, and political significance of such a development is most formidable. Between 1900 and 1955 our population doubled, but the proportion aged 65 and over more than quadrupled, growing from 3.1 million to 14.1 million, or from about 4 per cent to 8 1/2 per cent. Population experts predict that persons aged 65 and over will continue to become an increasing proportion of the population and therefore it is clear that the problem of caring for older people will continue to grow. Steps in the direction of meeting this problem have brought about a vast expansion of pension plans, both public and private. It is reported that in 1955 there were nearly 13 1/4 million beneficiaries or recipients of pensions, including Old Age and Survivors Insurance, and that the amount paid to them in that year was \$11.5 billion. But this is not a full measure of the problem of eroding fixed incomes. And the problem does not affect only individuals. It vitally affects countless institutions, of which our universities and colleges are outstanding examples, whose endowment funds would suffer under the grinding heel of relentless inflation. Perhaps I have already labored this point too much, because these elementary facts about the results of inflation are well known to you. Let me state a conclusion.

While we concern ourselves with the claim that tight money bears unevenly on certain segments of our economy and certain groups of our people,

I think we should be taking into account the devastating unevenness of inflation. Rational analysis buttressed by incontrovertible experience teaches that inflation ultimately impoverishes the masses and enriches the few. According to any scale of values which I consider decently acceptable, this is not tolerable. It must not be deliberate policy. It must not be complaisantly permitted.

A final word and I am through. We should not be deceived by the bland assertion that a little, controlled inflation may be the alternative to deep depression. This is completely invalid. Higher interest cost, - tight money, if you please, - contributing to stability by balancing saving with investment, does not set the stage for deep depression. On the contrary it helps to prevent imbalances from developing in the economy which might bring about depression. Correction of these imbalances is a means of avoiding depression. The role of the monetary authorities is to let the market forces generated by the competition for money bring about their own corrective and preventive measures. This is of the essence of our democratic way of doing things.

oooOOOooo