

THE ECONOMIC SITUATION

Delivered by  
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I have been asked to talk to you today about the performance of the economy in 1963. As I do so I want to include how monetary policy, the special responsibility of the Federal Reserve System, affects this performance. It is important that you, both as businessmen and citizens, understand how monetary policy operates and the problems which it faces. For, the extent to which it and other stabilization policies are successful has an important bearing on the prosperity of the nation, and our area, including Alton. It is not easy to appreciate the cause and effect relationship between changes in monetary policy and changes in economic activity. This is because the effects are so diffuse and because they may impinge upon us in a way which hides their origin. I like to think of the aspirin advertisement in which the tablet is dropped into the mouth of the spiraled tube--and it is gone by the time it reaches the stomach. This doesn't mean that the aspirin doesn't work--just because you can't see it. So it is with monetary policy.

One of the clearest illustrations of the relationship of sales, output, and employment to monetary policy is to consider what happens to the economy during periods of recession. In the 1950's we had three brief, mild downturns, 1953, 1957, 1960--in which total output fell on the average of 9.7 per cent and retail sales by 1.4 per cent. In each case the Federal Reserve System engaged in monetary operations which helped reverse the downward movement in business and restore prosperity.

In 1963 the System's operations were directed toward contributing to sustainable economic growth with reasonable price stability and a viable international payments position.

Before mentioning the salient features of monetary developments in 1963, however, perhaps I should briefly outline the ways by which the Federal Reserve System carries out its monetary policy. These "instruments" of monetary policy are mainly three. The most important is open market operations, or dealing in money market assets, mainly Government securities. When the System is buying, the result is that reserves of commercial banks are increased, which in turn means that bank credit is made more freely available to the economy. The reverse is true for selling securities. A second instrument is the Federal Reserve discount rate, or the rate charged member banks when they borrow from the Federal Reserve Banks. A third, which was not used during the past year, is changing the proportion of reserves to deposits that are required to be held by the commercial banks. It is mainly by these three tools--open market operations, the discount rate, and reserve requirements--that we carry out our responsibility for regulating the money supply in order to achieve the goals of growth, price stability, and international balance.

In retrospect, the economy had a good year in 1963. Retailing in the past year has flourished. Estimated sales in Alton and in the St. Louis Metropolitan Area as a whole were significantly higher in 1963 than in 1962. For the entire nation, retail sales were up 4.8 per cent. However, the general

business outlook a year ago was far from rosy. Economic activity in the nation had been on a plateau since the summer of 1962, and problems of inadequate domestic demand and balance-of-payments deficit were troublesome, as they had been for several years.

These two problems--internal and external--presented a dilemma in deciding on what monetary policy should be. To put more "zip" into the domestic economy, the prescription would be one of monetary ease. Reserves of the banking system would be increased to encourage credit and monetary expansion, lower interest rates, and, hopefully, greater levels of spending. However, with our payments to foreigners exceeding their payments to us, we were losing gold and running a foreign deficit. For this malady we would not want a monetary "pep pill," but instead a "tranquilizer," or maybe a "sedative." To be more specific, if we focused only on international considerations, monetary policy should have been restrictive, tending to raise short-term interest rates and thus to discourage the movement of capital abroad.

Rather than take either of these extreme courses, monetary policy steered a middle course. Unused resources in the economy made it possible for monetary and other Government policies to be moderately stimulative in that we did not have to be overly concerned that higher levels of spending would push prices upward. Throughout 1962 and indeed, 1963, consumer and wholesale prices remained relatively stable and presented no threat of renewed inflation.

Thus, monetary actions during the first half of the year were designed to foster expansion. Member bank reserves rose faster than usual and bank credit expanded at an annual rate of 11 per cent. Cash holdings of the public were relatively large, and the money supply continued to expand moderately.

In the first half of 1963, a rapid business expansion occurred. Industrial production rose at a 12 per cent annual rate for the first seven months of the year. Employment picked up nicely, and total spending on goods and services was slightly higher than in the last half of 1962.

Important factors behind this upsurge were a strong increase in the demand for steel (to build inventories), rising private construction spending, and stimulative Government fiscal transactions.

Unfortunately, these favorable domestic economic developments were countered by a new resurgence of balance-of-payments difficulties. Despite the fact that our trade position was strong and that the burden of Government aid and defense expenditures abroad was being minimized, the deficit for the first half of 1963 increased sharply over 1962. This occurred because of increased U. S. investment abroad. Long-term investment accounted for 70 per cent of the increase in the deficit, and short-term investments 25 per cent.

There were two immediate reasons for the increased capital outflow in the first half of 1963. In general, foreign capital markets have limited resources and are tightly controlled by governments. Thus, when foreign

capital needs rise during periods of prosperity, foreign demands for U. S. investment funds increase. Second, as the international economy becomes more integrated and greater confidence is placed in foreign currencies, short-term investment tends to be guided by the relative attractiveness of home and foreign short-term yields.

In mid-July steps were taken to attack this capital drain. First, to make borrowing costs in the U. S. for foreigners more comparable to costs abroad, an "interest-equalization tax" was proposed on foreign securities sold in the U. S. Second, short-term interest rates in the U. S. were raised in order to make investment here relatively more attractive.

Nonetheless, the Federal Reserve System has continued to supply additional reserves to the banking system, and both credit and money have continued to expand.

Since August, the pace of business activity has moderated. Industrial output, employment, construction and retail sales have increased less rapidly, although corporate profits maintained their healthy rate of increase.

Although domestic activity has paused, it has done so at record high levels. Meanwhile, the balance-of-payments situation has improved during the last half of the year as capital outflows greatly diminished. Preliminary estimates for the last half of 1963 show an improvement of \$3 billion over the first half, and the improvement in capital outflows largely account for the reduced total deficit.

To sum up for the year as a whole---1963 was a year of substantial growth. Total output in constant dollars increased 3.9 per cent, well above the average yearly growth of 3.1 per cent since 1951. Total employment rose 1.6 per cent compared with 1.0 per cent per year since 1951.

1963 was also a year of balanced growth and of sustainable growth. As I mentioned earlier, general price increases did not appear or threaten to appear. And although we experienced a discouraging adverse balance-of-payments situation in the first half of the year, for the entire year we managed to improve the deficit significantly over last year. The Federal Reserve System and other Government agencies have carefully coordinated policies toward this goal and have managed to do so without imposing heavy costs on the domestic economy.

With 1963 providing a background, what lies ahead in 1964? There seems to be a consensus among economic forecasters and pundits that it will be a "good year." Total output for the nation, as measured by Gross National Product is expected to be somewhere in the neighborhood of \$620 to \$625 billion, an increase of about 6 per cent over 1963. If this forecast proves correct, then we might expect somewhat greater growth in personal income. At the National Retail Merchants Association meeting in New York some two weeks ago, Professor McNair of Harvard, a leading marketing authority, forecast a 4-1/2 per cent increase in national retail sales in 1964, slightly larger than

the increase in 1963. For the St. Louis and Alton area, knowledgeable observers expect an improvement for 1964 of about the same size.

Regarding Federal Reserve actions, we must remember that what we do is largely determined by the underlying performance of the economy. If further growth is maintained without the appearance of significant deterioration in either of the two critical and related areas of price stability and the balance of payments, then monetary policy can continue to be expansive.

On the other hand, although the last half of 1963 saw our balance-of-payments deficit improve, this improvement can be traced in large part to our higher short-term interest levels in the latter part of the year and to the effects of the interest-equalization tax. There are some indications that lowering of capital outflows by these two measures may not be lasting. On the other hand, the outlook for our balance of goods and services and Government account does not look unfavorable. We shall have to be watchful of this problem as the year passes, particularly if foreign interest rates tend to rise and attract greater capital outflows.

Again, we have been blessed with relatively few problems of inflation in the last few years, but should rising expenditure during 1964 be associated with renewed inflation, greater weight would necessarily be given this problem in the formulation of policy.



Finally, we must remember that the present upswing is already one of the longest in the postwar era. Perhaps the pace will be continued, particularly so if the tax bill currently before Congress is passed, and is stimulative. But there is a possibility that the expansion might slacken, in which case the usual Federal Reserve action would be for more ease.

These are just a few of the eventualities that we in the System must bear in mind. Unfortunately, economics is not an exact science, and we cannot predict the phases of the economy as the astronomers do the phases of the moon. Which is not to say that economists and policy makers are operating in the dark, but only that our experience suggests that policy-making is a matter of judgment, and that informed judgment, keeping in mind its limitations, is better than uninformed judgment. Forecasting is necessary, but in our business it must be for the short run. The economy must be followed day by day. Fortunately monetary policy is highly flexible and can be changed promptly to meet existing needs.