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Statement of

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Chairman, Board of Governors of the Federal Reserve System

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As always, Mr. Chairman, the Board of Governors welcomes these discussions with your Committee.

Only five years ago, we were exploring the role of credit and monetary policy in some detail and at some length with a subcommittee of this Committee charged with making an inquiry into "Monetary Policy and the Management of the Public Debt: Their Role in Achieving Price Stability and High Level Employment." You will recall that one of the issues was the potential contribution of flexible monetary policy in fostering balanced and orderly economic growth. In our presentation, we emphasized that flexible monetary policy could make a positive contribution to stable economic growth, indeed was indispensable to it, though it could not do the whole job. Although monetary policy was only one of the instruments available to Government policy to help carry out the objectives of the Employment Act of 1946, it needed to be used if we were to have tolerable success in meeting those objectives.

In administering our responsibilities since that inquiry we have endeavored at all times to adjust our policies affirmatively and promptly to the changing economic situation. We have consistently acted to encourage such credit and monetary expansion as would be needed by a growing economy without inflation. We have resisted inflationary pressures by credit and monetary restraints whenever such pressures have mounted. We have relaxed restraints and made bank credit more available and eased credit conditions generally whenever inflationary tendencies have abated.

Anti-inflationary policies and anti-deflationary policies are inseparably linked. To achieve maximum success in contributing to stability, Federal Reserve policies, and indeed all types of government, as well as private, actions, must resist excesses on the upside if they are not to complicate the adjustment process on the downside. On the other hand, excessive stimulus during recession can jeopardize long-run stability.

Throughout the period since flexible credit and monetary operations were resumed in early 1951, we have endeavored to shape our policies continuously in accordance with basic economic forces and conditions. The economic situation, to be sure, has been influenced in some degree by our policies, but it has not been created by them. Many other forces are also at work in a dynamic enterprise economy.

This background is relevant to an understanding of more recent developments. A year ago when I testified before your Committee, economic conditions were characterized by strong inflationary pressures. This was exemplified by the substantial rise that was occurring in gross national product measured in current dollars compared with the relatively modest increase that was being experienced in product measured in constant dollars. In spite of the preceding credit and monetary actions that had been taken, money was losing its value at a pace that was a matter of deep concern to all.

Inflationary excesses had clearly gotten ahead of us and the economy stood in danger of an inflation crisis. The adjustment problems that the economy is confronting today are the aftermath of those excesses.

In retrospect, none of us participating in economic decision-making adequately appraised the speed and force of inflationary boom. Consumer credit rose substantially in 1955. Businesses vastly increased their expenditures for plant and equipment in 1956 and 1957. Bankers and other lenders greatly expanded their commitments to lend. Labor unions sought current wage increases--and commitments for future increases--that pressed against or exceeded gains in productivity. However, inflationary trends seem to have halted before creating maladjustments of such severity to lead to a protracted period of liquidation and structural realignment in the economy.

Inflationary trends continued through the summer months of last year. There was an alarming spread of the belief, not only in this country but also abroad, that creeping inflation under modern economic conditions was to be a chronic and unavoidable condition. Reflecting this view, common stocks, the most popular hedge against inflation, rose sharply in price in July to a level where for the first time in two decades their yields fell below the yields on high-grade bonds. Also, credit demands generally continued to show great strength, and interest rates were rising. Large city banks on August 7 raised their lending rate to prime business borrowers from 4 to 4-1/2 per cent. In this situation, Federal Reserve Bank discount rates, which were below market rates by a widening margin, were raised from 3 to 3-1/2 per cent, thus increasing member bank costs of operating on the basis of borrowed reserves.

In late summer and early autumn, however, developing uncertainties here and abroad began to affect the short-term economic outlook. In European exchange markets, widespread expectations of changes in exchange rates fostered large speculative movements of funds between European centers. These expectations in part reflected further accentuation of inflationary developments in some key countries, despite actions to tighten credit that were taken in various countries during the summer. It was not until late September, after the Bank of England established a 7 per cent discount rate, that it became clear that key foreign currency values would be maintained and that inflation would be strongly resisted.

In this country, the unexpected curtailment in defense payments and changes in procurement policies that were inaugurated during the summer, to avoid breaking through the debt ceiling, had an unsettling effect on business. In September, retail trade, which had been at record levels in July and August, began to show signs of sluggishness and this continued. Partly as a result of all of these developments, common stock prices, which had already begun to react from their extremely low yield relationships to bonds reached in July, broke further and passed in late September through the lower edge of the trading range that had prevailed during the past two years. With changing attitudes toward the economic outlook, adjustments that had been occurring for some months in various lines of activity, including some capital goods lines, came to be reappraised by businessmen, investors, and the public generally. In contrast to earlier indications of strong credit demands, bank loans to business during early autumn decreased contrary to usual seasonal tendencies.

The pace of business was maintained for a time despite these uncertainties, with employment and industrial output continuing at relatively high levels in August and September. By late October, the composite of most recent economic information suggested that inflationary pressures might be abating, and open market operations were modified to lessen restraint on bank credit and monetary expansion. By mid-November, information becoming available, incomplete though it was, indicated that general downward adjustment was setting in. In response to this evident change in basic economic conditions, Federal Reserve Bank discount rates were reduced from 3-1/2 to 3 per cent.

Since that time, other successive System actions were taken in accordance with information increasingly indicative of the emergence of recessionary trends. Thus, monetary policy contributed to a marked easing in the credit and capital markets. This is illustrated most dramatically by the very sharp drop in market rates of interest, the sharpest drop for any comparable period of which I have knowledge. This adjustment in credit and capital markets is helping to facilitate and cushion other adjustments in the economy as well as to strengthen demands in important areas dependent on credit financing. It is thus helping to set the stage for recovery in activity and employment as soon as other developments contribute to revival.

History shows that our market economy has cyclical characteristics, and the consequences of this irregularity in terms of hardship and unemployment are a matter of deep concern to everyone. When downward readjustment becomes unavoidable, it is incumbent on business enterprises, financial institutions, and labor organizations, as well as Government generally, to adjust policies and programs to foster recovery. We have been concerned, for example, at the decline in output and employment while prices generally have been maintained and some prices even have risen further. How soon recession is checked and recovery is resumed will depend in some part at least on the speed with which economic corrections and adaptations are made in factors beyond the province of monetary policy, that is to say, in business pricing, other selling practices and efficiency, in wage bargaining, in various financing arrangements, and in the incentives to consumers to buy.

These general remarks are by way of introduction, for you have requested in advance that I address myself today to four major questions. The balance of this statement is concerned with answers to these questions, but I have rearranged the order in which I will take them up.

1. "What is the current policy of the monetary authorities?"

In recent months, the Federal Reserve System has operated to make bank and other credit more available and cheaper.

Over this period, open market and discount policies were used in a complementary fashion. Open market operations provided sufficient reserves to permit member banks not only to repay a substantial portion of their indebtedness to the Reserve Banks, but also to accumulate some addition to reserves available for bank credit expansion. Discount rates were lowered on two occasions, mid-November and mid-January, from 3-1/2 to 2-3/4 per cent. These reductions in discount rates assured member banks that, if loan operations should require temporary borrowing of Federal Reserve credit for reserve purposes, its cost would be cheaper.

As a result of these developments, bank credit, capital market credit, and mortgage credit, have become more readily available to borrowers who have delayed or postponed financing as well as to borrowers seeking to finance new projects. Furthermore, the cost of credit has been reduced as a result both of lower rates of interest and more favorable terms of borrowing. These conditions are favorable to monetary expansion.

At the end of 1957, total customer credit for purchasing and carrying securities was 10 per cent less than the amount outstanding at midyear and back to the level of early 1955. Thus, the need for preventing an excessive expansion of stock market credit through the higher level of margin requirements had abated. The Board of Governors in mid-January reduced margin requirments for purchasing or carrying listed securities from 70 to 50 per cent.

2. "What would you regard as the proper division of labor between tax policy and monetary policy as instruments of economic stabilization during the coming year?"

From the standpoint of economic stabilization, tax policy needs to be reviewed in relation to expenditure requirements. Therefore, it is appropriate to consider monetary actions in the perspective of general fiscal policy rather than just tax policy.

The combination of fiscal and monetary policies that are appropriate at any particular time depends upon the circumstances prevailing and upon the feasibility of action in one field or the other. These policies are most effective in achieving their purposes when utilized in a complementary fashion. Yet, to an extent, each can be used in varying degrees independently of the other.

Fiscal policy is less flexible than monetary policy. Nevertheless, the so-called built-in stabilizers in the Federal Budget do come into operation promptly. As personal income and corporate profits decline, tax collections relatively decline more sharply. At the same time, unemployment insurance payments increase. These features of the budget and fiscal system are already operating to cushion the reduction in private incomes and expenditures.

Whether further action is desirable in either or both of these fields depends on the unfolding economic and financial picture. As of the present, the division of labor between monetary and fiscal policy is about as follows. Through the automatic stabilizers, fiscal operations have provided some offset to the decline in incomes and expenditures. Monetary policy has actively increased the availability and lowered the cost of credit, thereby encouraging loan-financed expenditures, raising capital values, and enhancing liquidity throughout the economy.

3. "What, if any, elements exist in the current situation which suggest or might permit a resurgence of inflationary forces in the next 12 or 15 months?"

In retrospect, it is now clear that economic activity in the United States reached a peak in the third quarter of 1957 and that it has been receding since then. Thus far, the downward movement has been reminiscent in many ways of the declines that occurred in 1948-49 and in 1953-54. The early stages of all three postwar cyclical contractions have been marked by rather rapid declines in output and employment in industrial sectors. It may be remembered that the two preceding contractions were moderate and short-lived.

Resurgence of inflationary forces in the next 12 or 15 months is contingent on general revival of demands, output, and employment; on the vigor of such a revival; on institutional forces such as wage bargaining, cost plus purchasing practices, and easy credit terms that may foster price advances; on market pressures of demand in relation to supply in particularly strategic areas; and, finally, on the nature and timing of governmental actions to deal with the developing economic situation generally or with key sectors of it.

No one can speak with certainty about the future course of economic activity. There is, in fact, a range of views currently held regarding the duration and extent of this recession and of the timing and vigor of the ensuing recovery. In my own view, the underlying strengths of the economy are many. After not too long a period of readjustment and realignment of activities, healthy revival should set in, progressing to new records of economic performance and new high levels of national well being. But everything depends upon the speed with whcih needed readjustments and realignments of activities are made.

We are all, of course, well aware that reasoning by analogy may be misleading and that history does not repeat itself. In the two preceding postwar recessions, lows in activity were reached in less than a year from the cyclical peak and recovery to new high levels of output, demands, and employment was rapid and substantial. With the exception of the catastrophic depression of the early 1930's, the downward phase of every cycle since World War I has been over or virtually over in the course of a year.

As in our other postwar recessions, many basic forces are present in the situation favorable to recovery.

(1) For instance, as I have already mentioned, credit and capital market conditions have already responded to relaxed monetary policy and are much easier than they were a few months ago. Important financial adjustments also have already been started. By borrowing from the capital market, business firms have been able to repay bank debt, thus rebuilding the liquidity positions of both financing institutions and business enterprise.

(2) Consumer incentives to achieve still higher standards of living are strong, and research continues to provide new products of wide consumer appeal. As a group, businessmen and consumers continue to have confidence in the long-term growth prospects for our economy.

(3) Population increase has been maintained at a rapid pace--the rise of 1.8 per cent in 1957 compares with a postwar average of 1.7 per cent, and hence the market is expanding steadily.

(4) Consumer incomes have shown some cyclical decline recently, but the decline has been small and moderated by unemployment compensation benefits. Consumer demands are supported by a record volume of financial assets, the ownership of which is widely distributed. Growth in such assets was rapid in 1956 and 1957, while growth in consumer instalment and mortgage debt, though not small, was at a much slower rate than in 1955. The availability and terms of mortgage credit have recently become more favorable to borrowers.

(5) At the State and local government level, community demands for schools and teachers, for roads, public buildings, and other community facilities are continuing large and insistent.

(6) For the Federal Government, postwar budgets have been dominated by the need to cope with critical international stresses and tensions and to provide an adequate defense under conditions of major scientific advance and rapid technological change. National security and related problems continue to be urgent.

(7) Insofar as international economic developments are concerned, Western Europe still shows considerable strength. Industrial activity, while no longer expanding, has generally been maintained at or close to record levels. In general, balance of payments positions have improved although in several countries reserves of gold and foreign exchange are not as large as might be desired. Outside Europe, however, raw materials producing countries are facing difficulties because of declines in prices or volume of their exports.

A primary uncertainty with respect to the timing and pace of economic revival and renewed growth relates to the course of business outlays for new plant and equipment. Some observers view the business capital goods boom of the past three years as having provided a margin of industrial capacity over prospective demands greater than can be absorbed quickly. These observers tend to expect a more protracted period of adjustment than took place in the two preceding cycles.

This concern may turn out to have been well founded, but it may be noted that capacity never appears more excessive than in the midst of recession. Cyclical recovery, in due course, can certainly be expected to be accompanied by effective and profitable use of the economy's capacity to produce and by still further additions to capacity. The important factors working to expand business capital investment in the period ahead should not be minimized. The advance in the technology of production, in part the result of the huge investment in research of recent years, has been rapid and can be expected to continue. Incentives to reduce costs, to meet competition, and to sustain or improve profitability, are strong.

If revival in over-all economic activity becomes vigorous, there will be, of course, the accompanying possibility of resurgence of inflationary pressures. Postwar experience has demonstrated that, in a period of expanding demand, upward pressures on prices and costs can develop quickly. Once under way, inflationary movements tend to spread themselves throughout the economy, not only because of normal market reactions, but also because of a variety of institutional arrangements such as cost-of-living clauses in wage contracts and cost-plus arrangements in business or Government procurement contracts, in part designed to protect one group or another from the ill effects of inflation. Currently, it may be noted, consumer prices reached a new high in November and remained at that high in December, notwithstanding significant declines in activity and employment.

As I said earlier, those charged with responsibility for national economic policies must at all times reckon with the dangers both of inflation and of deflation. The central policy problem, in one sense, is to prevent either inflationary trends or deflationary trends from becoming dominant. Public policies for one objective or another can have effects that go far beyond those that are intended. Both fiscal and monetary policies must be carefully formulated to exert enough pressure but not too much. That is a difficult task.

4. "If the inflationary forces continue to abate during the year, what program would you recommend as to priority and specific actions in the fiscal and monetary fields?"

Everyone hopes that any recession will be moderate and short-lived.

One possibility for the year ahead is that revival may develop without renewed inflation, at least in its early stages. Under such circumstances, the task of monetary policy would be to foster revival and resumed growth, but to be ever alert to the potentials of inflationary pressures and to take prompt action should they recur.

Another possibility is that recession may be deeper and more protracted than many now anticipate, with a greater degree of under-utilization of manpower and industrial resources and with manifest deflationary tendencies. In such an eventuality, further monetary action would need to be considered, both to increase the liquidity of the economy and to encourage expansion of spending financed by credit. Monetary policy by itself, however, cannot assure resumption of high-level employment and sustainable economic growth, although ready availability of credit at reasonable cost is an essential condition for recovery.

This country is now in the process of re-evaluating what share of its potential productive capacity to devote to current consumption and what share to devote to investment in its future--in the form of outlays not only for defense and capital equipment but also for research, education, and foreign assistance. This process of reappraisal will continue for some time and in our thinking we ought not to forget the enormous growth potential that we have over the longer run and the need that we shall have for an adequate volume of savings to finance it.

With respect to fiscal policy, should the present recession appear to justify some action in this field, I should like to emphasize that we should weigh carefully both the need to meet the challenge to our defensive strength and the need to keep our economy strong and progressive.

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