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Statement of

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before the

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MONETARY POLICY AND ECONOMIC GROWTH

Mr. Chairman:

It seems to me that perhaps the most helpful contribution I can provide to your Committee's annual review of the President's economic report is to make some supplementary comments on financial and monetary developments over the last year.

Our financial environment changes constantly, as this Committee knows well, but some of the changes that took place last year were dramatic indeed.

During 1959, credit expanded by $60 billion in all--one-third more than the previous peacetime record. Mortgage debt, most of it for housing, increased by a record $19 billion. Consumer credit outstanding rose about $6.5 billion, equalling the previous record of 1955. New borrowing by State and local governments continued in near-record volume, and new borrowing by the Federal Government exceeded all peacetime records. At the end of the year public and private debt was at the highest level in history.

The American economy and the American people would be in a very different and a vastly worse position today if this enormous expansion of credit had been financed by the large-scale creation of additional funds by the banking system and a consequent rapid and inflationary increase in the money supply.

Fortunately, that danger was averted--in 1959 at least. To date, the task of supplying this huge demand for credit without severe inflationary consequences has been accomplished chiefly by the sound and democratic process of letting those who would borrow provide those who would save with an inducement to risk voluntarily the loan of their savings. The role of the banking system, which obviously is influenced greatly by Federal Reserve policy and operations, has been held to that of an intermediary between borrowers and savers.

Let me illustrate the working of this process by referring briefly to the events of 1959 as they are reflected in the Federal Reserve's flow-of-funds accounts, a body of quarterly published data developed in part as an outgrowth of investigations set in motion by one of your subcommittees into the need for improved statistical information.

The commercial banks, it is true, did expand their loans in 1959 by almost $12 billion--thereby equalling the previous record of 1955. The important thing for the economy, however, is that the banks raised the funds for this lending in large part by selling Government securities they owned to the nonbank public.

Thus, the banks performed an intermediary service by obtaining funds from savers, to whom they transferred investment securities, and by passing the funds on to others who had a need to borrow. This flow of funds from savers to banks to borrowers did much to assure that the need for credit was met without a dangerous increase in the money supply. It did, however, bring about an increase in the turnover or rate of use of the existing money supply and, by so doing, produced much the same economic and financial effect as would have been produced by a modest increase in the money supply without the accompaniment of a faster rate of use.

The activity last year of the nonbank public--meaning for the most part consumers and business concerns--in supplying borrowers with funds through the process of investment was truly extraordinary, and it did not stop with the purchase of Government securities sold by the banking system. The upswing in this activity shows up strikingly in the flow-of-funds data that I mentioned earlier. There, it appears that consumer and business investors increased the net amount of their purchases made directly in securities markets from about $4 billion in 1958 to almost $20 billion in 1959--a jump of 400 per cent in a single year.

The efficient and economically healthy flow of funds from savers to borrowers, directly and through intermediaries, did not ccme about without a price. The price was, of course, a rise in interest rates. These rates, representing a penalty to those who use someone else's money and a reward to those who save and risk their funds in loans and investments, rose in some instances to the highest levels in three decades. What happened is readily apparent: the pressure of demand for funds arising from a combination of forces--a large Federal budget deficit, high residential construction activity, rising expenditures for consumer durables and for inventories and to some extent fixed capital, plus the continued high level of expenditures by State and local governments on community facilities--converged to bring about a competition to borrow that drove interest rates upward; the rise in interest rates, in turn, operated to induce the savings and investment necessary to supply borrowing demands. In summary, the direct effect of the greatly enlarged credit demand was to bid up interest rates generally and to cause some changes in the relationship of interest rates among the different credit markets; the resultant effect was to draw more funds into the credit market and to shift some funds from accustomed uses.

Let me add something here to what I said about the banking system's service in 1959 as an intermediary between the saving public and the borrowing public. On the one hand, the saving public, besides purchasing a large volume of securities as I described, increased their time deposits by about $1.5 billion. On the other hand, the borrowing public increased the amount of their loans obtained from commercial banks by nearly $12 billion. To raise funds to meet the heavy demands on them for loans, the commercial banks sold about $8 billion of their Government security holdings in the open market, while the nonbank public, as stated earlier, was increasing their purchases in that market. Thus the banks, in effect, drew out of the market, from individuals and corporations not engaged in lending, the funds to meet the specialized credit demands of borrowers--as, for instance, many small business concerns--who could not themselves have raised funds in the market because their needs were unsuitable for general market participation.

The vital role that the Federal securities market plays as a clearing house for credit flows is apparent in the circumstances described. In 1959, this role was much larger than in other recent years. Federal net borrowing of $11 billion and bank sales of Governments of nearly $8 billion required absorption of around $19 billion in Federal securities by other investors. This, taking into consideration that the Treasury was having to raise new funds while shifts were taking place in Government security ownership, goes a long way toward explaining the rise in both long- and short-term rates that we experienced during the year. It is also illuminating evidence of the responsiveness of nonbank investors to attractive interest yields.

The relation of Federal Reserve policy to changes in interest rates is often misunderstood. Federal Reserve operations to release or absorb bank reserves unquestionably influence short-term and also long-term interest rates, but the extent of this influence is easily exaggerated. Monetary policy is effective only so long as it works in general consonance with the economic realities underlying the situation. These realities include the basic demands for funds, whether to meet seasonal needs, other short-run needs, or for capital formation, and the basic supply of funds through saving. Federal Reserve actions cannot for long enforce rates of interest on the market that are either above or below the rates that maintain a balance between saving and investment.

Changes in the rate of monetary growth can represent only a very small part of the total flow of funds through credit markets. If the rate of monetary growth were raised with the specific objective of adding to the supply of funds in an attempt to keep interest rates down, the additional dollars in the spending stream would certainly work to raise average prices. The process of monetary inflation is widely understood by both savers and borrowers. Such action would generate expectations of further inflation on the part of both groups. The incentives of the market place, present and prospective, would unquestionably tend to increase borrowing and discourage saving and in all likelihood rates would increase.

In the longer run, the way that monetary policy can contribute to a lower level of interest rates is through its role in maintaining a stable value for the dollar. It is only in an environment of confidence in such stability that savings will accumulate and credit will flow in an orderly way and in expanding volume. Efforts to maintain an artificial level of interest rates, either too high or too low, can only lead to cumulative financial disequilibrium, first distorting and then disrupting healthy economic growth.

Whether monetary policy as administered by the Federal Reserve System has been, at particular times, too easy or too tight is a matter of judgment. At one time or another, we have no doubt erred in some degree in each direction. But the System has consistently endeavored to cultivate confidence in the stability of the dollar--by combatting deflationary tendencies in periods of slack and inflationary pressures in periods when resources were being intensively utilized.

I want to emphasize again that the Federal Reserve System wants low and not high interest rates; it wants as low a level of interest rates as is consonant with sufficient savings to finance the investment necessary for desirable and rapid economic growth. We cannot say that a steadily swelling stream of savings and investment is the only essential for satisfactory growth, but, especially in a country where the natural resources are already highly developed, it is a vital element.

Record of Economic Growth

The subject of economic growth has received exhaustive study by your Committee during the past year. It is an important subject because only growth can produce the substance with which to achieve our individual and national aspirations. At the same time, economic growth is a confusing subject because it means so many different things to different people. Some seek growth primarily as a requisite of effective defense against potential enemies. Others want it as a means of improving civilian living standards. Still others regard growth as a way of assuring employment of a growing labor force. Transcending and including all of these, perhaps, is the idea that economic growth is needed to express the vitality of our economic and political way of life.

As economic abundance in the United States expands and is more widely shared, agreement on appropriate economic goals becomes more urgent. These goals can never be blueprinted exactly--as has been brought out so clearly in the hearings before this Committee. They are not solely materialistic and they are not all subject to expression in statistical terms. They include, for example, the improved quality of our educational system and of our health services--not just additional school rooms or hospital beds. Despite difficulties in measuring true growth precisely with the tools now at hand, we have made some progress and now know much more about the nature of growth than was known some years ago.

Early in its existence, the Board recognized that measurement of physical output was essential for proper formulation of monetary policy, and undertook a special responsibility for the statistical measurement of industrial output and its change and growth. This, it is true, is only part of our nation's total output of goods and services, which is measured by gross national product. However, in an advanced economy, in which industrial activity is a dynamic central element, growth in the physical volume of industrial output merits special study in its own right because of its central role as a force shaping total growth.

When I appeared before this Committee last summer, I noted some preliminary findings of the recent revision of the Board's index of industrial production, principally the greater industrial growth shown by the newly revised index. Since then, the final results of the new index have been published, thus supplementing the tools for analyzing past and future changes in the industrial sectors of our economy.

Industrial production is the output of real goods produced by our factories, mines, and electric and gas utilities. Our revised index shows that, since 1947, industrial output has grown 4.1 per cent per year, as compared with 1.7 per cent for population. This is a growth in real industrial output per capita of over 2 per cent per year. In other words, we are producing 31 per cent more industrial product for each man, woman, and child in America than we were at the beginning of the period. Output per industrial worker has increased even more rapidly--at the rate of 3.7 per cent per annum over the same period.

The revised index of industrial production also introduces a new grouping of total output. Output measures for finished goods have been grouped into the broad market categories for consumer goods and equipment, and the measures for output of materials have also been grouped together. Briefly, this new grouping suggests that over postwar years, civilian production, and particularly the production of consumer goods, has expanded almost without any evident slackening in pace at a rate of growth of 3.7 per cent. Moreover, the cyclical interruptions in the output of civilian goods, especially consumer goods, have been relatively small. It is mainly in the production of equipment, including defense goods, that output has shown greater fluctuation about its expanding trend.

Conditions Required for Continued Growth

While industrial growth, as measured by the production index, reflects physical volume of output, many measures of growth are expressed in terms of current dollars. We must constantly guard against mistaking increases in dollar magnitudes for real economic growth. It is sometimes suggested, when the rate of expansion slows down because the economy is operating close to capacity, that a more rapid expansion of bank credit and money would stimulate greater aggregate output. In fact, such an attempt would only lead to a bidding up of costs and prices as various sectors compete for limited resources. It is true that this would increase temporarily the gross national product measured in current dollars, but it would not involve any real growth. Quite aside from its other evils, inflation brings about misapplications of resources that actually reduce the true value of current production. There must be sustained confidence in a stable dollar for such adverse developments to be avoided.

Sound growth depends on a number of factors besides confidence in a stable dollar. In my own view, the following are the chief supplementary factors:

1. Balanced and sustained demands for labor and for the products of business;

2. Improvement in technology and skills;

3. Adequate capital formation based on voluntary savings;

4. Greater mobility of resources; and

5. Sufficient flexibility of individual prices.

Although there have been three postwar recessions, demands for labor and for the products of business have been reasonably well sustained over this period. During each of these recessions, stability of consumption helped to stimulate early revival. This stability in final demand encouraged entrepreneurs to maintain capital expenditures at surprisingly high levels even during temporary recessions. Such expenditures fluctuated moderately considering their long history of instability.

How much further the process of economic stabilization can be carried remains an uncertain issue. All men of good sense want to see our economic resources used fully and all men of good will want to have employment opportunities available for those willing and able to work. Satisfactory economic growth and reasonable price stability are not only compatible goals, in my view, but they are necessarily interdependent. At the same time we all recognize that some fluctuations in prices and employment are probably unavoidable and that, in the present state of the economic arts, it is hard to see how complete stability could be achieved without stifling some developments in our economy potentially favorable to growth.

Advancing technology and improvement of skills depends on educational processes and the general cultural environment. Our national pride has been pricked by discovery that other nations have beaten us in some aspects of technological development. This evidence is found not only in military hardware but also in the mounting competitiveness of the rest of the world. Products from abroad are increasingly penetrating our markets. This challenge, however, may well provide the stimulus for new achievements on our part.

If we are to maintain our competitive position in the world, we must also make regular additions to our productive capital and to our efficiency. Adequate capital formation depends both on the drive of business to make the capital investment and the availability of adequate funds from voluntary saving.

Mobility of resources must receive continuous attention. Near the top of successive postwar peaks in activity, unemployment has tended to be somewhat higher. In part, this may be due to structural imbalances growing out of the problem of transferring the labor force from industries made obsolete by growth to areas of higher labor demand. Such imbalance may also stem from the problems of adapting workers to the technological and sociological demands of the service industries, which are the more rapidly growing sources of urban employment.

Flexibility in the shifting of resources, of great importance for maximum growth, is extraordinarily difficult to achieve. One of the effects of growing productivity is to reduce the amount of resources required in particular industries, especially those in which end-product consumption, such as consumption of food, grows at a slow, steady rate. The process of moving resources aggravates our cyclical difficulties and creates a problem of structural unemployment. Steps to lessen the economic loss to the nation and the hardships for individuals resulting from shifts in the pattern of production are an important public responsibility.

If we are to be able to continue to rely on the price mechanism to effect the necessary adjustments in a growing economy, prices of both end products and the factors of production must move freely in response to shifting demand and supply conditions. Imperfections in the price mechanism must be rooted out wherever they may exist, if our free enterprise economy is to realize its full potential.

Prospects for 1960

In early 1960 the economy continues to show a sharp pick-up from the period of hesitation caused by the steel strike. Economic activity is vigorous and prices are reasonably stable. Nevertheless, it is possible we may encounter a renewed spiral in the upward movement of prices, or, perhaps, find that the underlying strength in the situation is not so great as most observers now feel. In these circumstances, all of us are faced with a particularly sensitive problem of maintaining prosperity by endeavoring to prevent either a renewal of inflationary pressures or development of deflationary tendencies.

I sincerely hope that our part in this task as monetary authorities can be aided by a healthy budget surplus of an amount at least as large as the one outlined in the President's Budget Message. Experience since

1957 suggests that a surplus of this size is a minimum condition of reasonable fiscal health. The relatively brief decline in economic activity that occurred in 1957-58 resulted in a deficit of over $12 billion in fiscal 1959. If a level of economic activity as high as marked 1959, and which is projected in the budget estimate for 1960, results in a barely balanced budget in 1960 and a budget surplus of no more than $4.2 billion in fiscal 1961, the average result of the full period is a net deficit.

Such an outcome would hardly represent symmetrical economic policy. It would therefore appear that larger budget surpluses are needed in times of prosperity if we are to avoid having to make regular and persistent increases in the public debt. The relatively favorable outlook for balance between saving and investment in the period ahead, with the accompanying prospect of less pressure on the rate of interest, depends in large part on the improved fiscal position of the Federal Government.

I doubt that anyone could be more aware of the real limitations of monetary policy than are the members of the Federal Reserve Board. It is, however, the area of responsibility which has been given to us and in the discharge of that responsibility it has seemed to us that the most constructive contribution monetary policy can make to the vigorous, healthy growth of the economy in the present circumstances is to maintain confidence in the value of money, and thus encourage people to save and invest in the basic capital improvements that add to our nation's productive strength.

It is relevant to here refer to some statements that I made in the closing portion of a letter to Chairman Douglas on December 9:

"My interest in a monetary policy directed toward a dollar of stable value is not based on the feeling that price stability is a more important national objective than either maximum sustainable growth or a high level of employment, but rather on the reasoned conclusion that the objective of price stability is an essential prerequisite to their achievement.

"I want to emphasize that I am most concerned with the preservation of freely competitive markets and the correction of any institutional imperfections which exist in the working of the price mechanism. While such imperfections cannot be corrected simply by a sound monetary and fiscal policy, they surely cannot be corrected by an unsound financial policy.

"Nor does a sound general monetary policy necessarily, in itself, accomplish the optimum distribution of loanable funds among various sectors of the economy. It is not only the right but the duty of Government to assure that socially necessary programs are adequately financed. But, again, this objective can never be well served by unsound general monetary or fiscal policies. If, as a matter of public policy, the financing of school construction, for example, should have an overriding priority in the allocation of resources, this can be accomplished in a number of ways, but we can be sure that it would not be accomplished by the general expansion of bank credit and money."

In conclusion, I should like to add a word about what monetary policy can and cannot do. It cannot effectively peg interest rates. It cannot prevent monopoly. It cannot assure that the financial needs of all socially desirable activities are met without intervention by Government. It cannot be relied upon to cover Federal deficits. Alone, it certainly cannot assure either stability or growth.

What a correct monetary policy can do is to foster confidence in the dollar, so that our people can and will save and invest in the future with reasonable assurance that their plans will not be frustrated by irresponsible changes in the value of money.