

MONTHLY



Review

**FEDERAL RESERVE BANK
OF ST. LOUIS • P. O. BOX 442 • ST. LOUIS 66, MO.**

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The Steel Strike and Monetary Developments

IN RECENT WEEKS there was a moderation in the demand for credit. Many interest rates worked lower, and bank credit and the money supply increased less than seasonally. Also, the turnover of money decreased. In view of a smaller production of goods and services because of the prolonged steel strike, a contraction in bank loans, money supply, and velocity of money might have been expected.

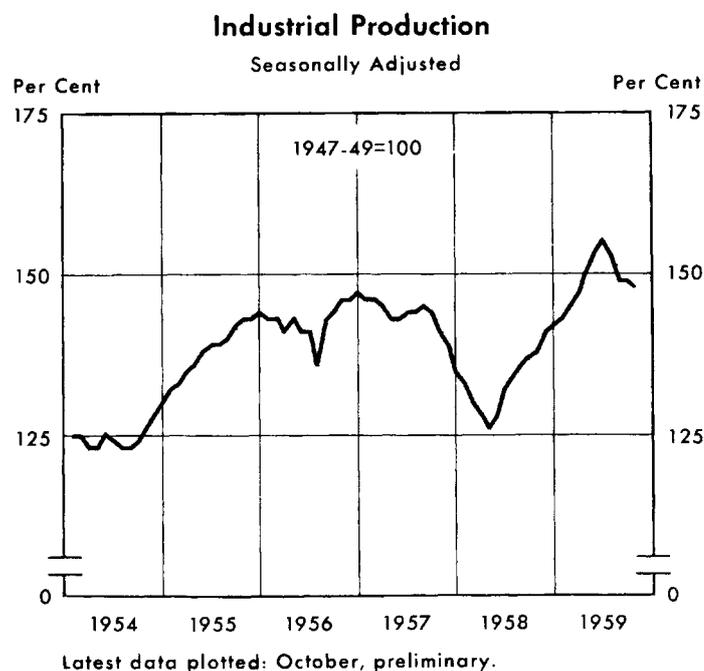
The Strike Reduced Activity

The steel strike, which began in mid-July and was ended for a cooling-off period by an injunction in early November, can be classed among the most serious in the nation's history. Over a half million steel workers had been away from their jobs. In addition, copper workers have been on strike since August, directly idling about 40,000 more persons. Also, it is estimated that by early November shortages of steel and copper had caused another third of a million to be unemployed; many others were on a short work week. Firms in a wide range of industries were affected, and their number had been growing each week. Auto assembly lines, appliance and tractor plants, and construction projects have been shut down.

It is said that the cost of the dispute in terms of wages, profits, and production lost has already run into billions of dollars. While the industrial production index in June was at the rate of 155 per cent of the 1947-49 average, by October it was estimated that the index had fallen to 148, and it is likely that in early November production was at an even lower rate than in October. After the strike end it will probably be several months before steel supplies will have returned to normal.

Demand for Credit Moderated

With more and more of the country's productive capacity being idled because of the lack of steel, the demand for credit became less intense. Some of the credit contraction may have been an adjustment to heavy anticipatory borrowing prior to the strike. The smaller demand for funds relative to supply was reflected in interest rates. Market interest rates, which had been rising for over a year, generally remained unchanged or declined somewhat over the past two months. Average yields on high-grade corporate

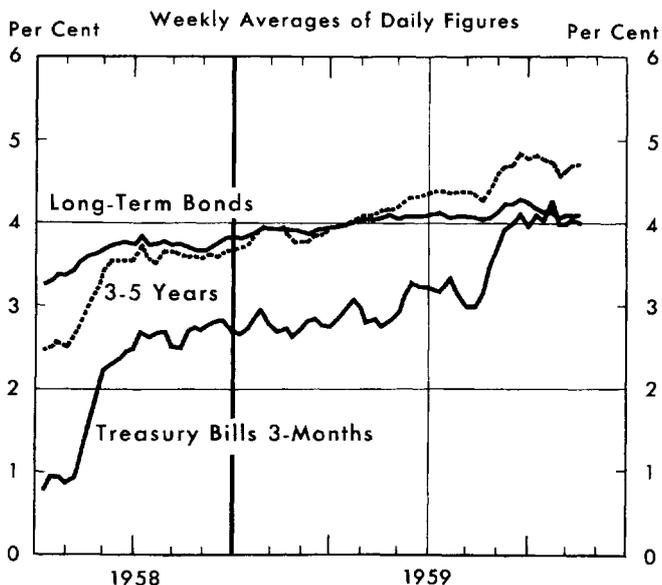


Source: Board of Governors of the Federal Reserve System.

bonds were at about the same level in early November as in mid-September. Interest rates on long-term Government bonds declined from 4.28 per cent on September 15 to 4.10 per cent on November 13. Over the same period yields on 3- to 5-year Government issues fell from 4.86 per cent to 4.62 per cent, and rates on three-month Treasury bills declined from 4.22 per cent to 4.06 per cent. Interest rates on commercial paper issued by sales finance companies were marked down from 4½ per cent to a level of 4 per cent.

The recent decline in the demand for credit has been reflected in banking statistics. During the period August 19 to October 28, loans at weekly reporting banks rose about \$650 million, or 1.0 per cent. Usually, loans at these banks rise at a much more rapid rate in the fall, and earlier this year they were increasing faster than the seasonal pattern. Indications are that the less-than-seasonal rise in loans did not result from increased "pressure" on bank reserve positions. Member bank borrowing from the Federal Reserve Banks averaged \$925 million in the ten weeks as against \$970 million in the previous ten weeks. Net borrowed reserves (borrowings less excess reserves) averaged \$470 million in the mid-August through October period compared to about \$500 million during the earlier summer period.

Yields on U. S. Government Securities



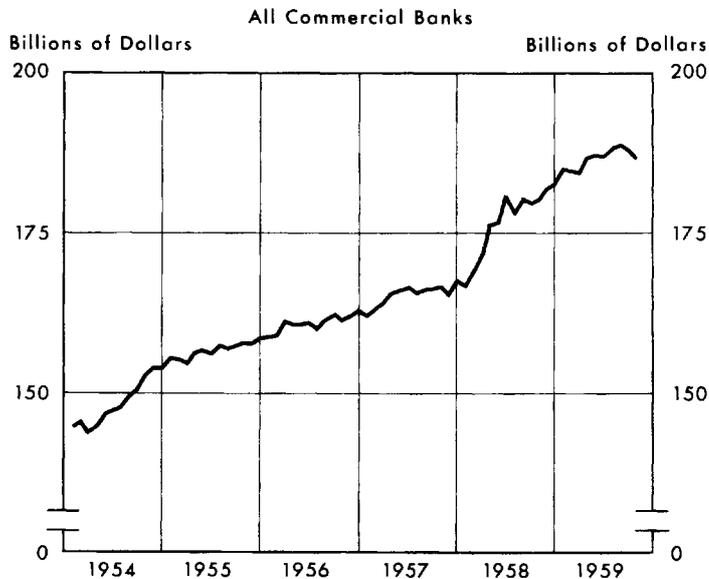
Latest data plotted: Week Ending Nov. 13, preliminary

Source for all charts on this page: Board of Governors of the Federal Reserve System.

Money Supply Declined

Weekly reporting banks reduced their investment portfolios by \$1.3 billion during the August 19-October 28 period, continuing a trend which began over a year ago. Hence, total credit at these banks fell about \$640 million during a period when it typically rises. Reflecting the bank credit developments, the money supply, seasonally adjusted, declined about \$2.5 billion, or 1.8 per cent from the last Wednesday of July to the last Wednesday of October.

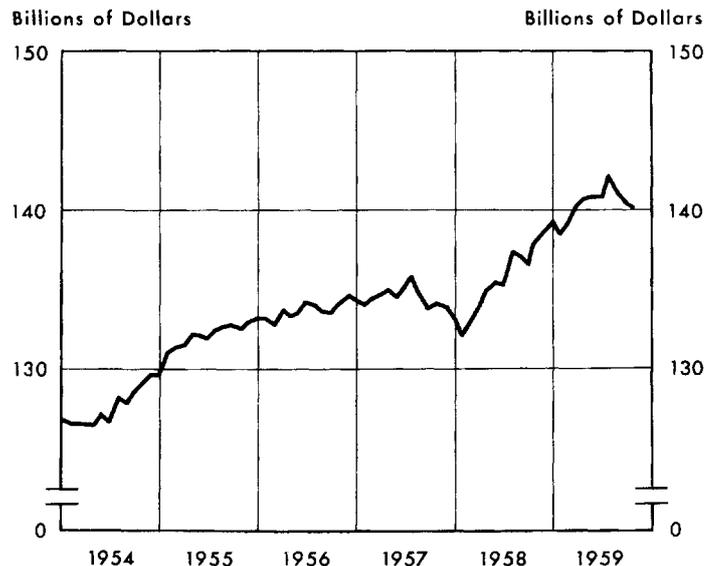
Total Loans and Investments



Latest data plotted: October, preliminary

Seasonally adjusted data for last Wednesday of month.

Money Supply



Latest data plotted: October, preliminary.

Demand deposits adjusted and currency outside banks seasonally adjusted for last Wednesday of month.

In addition to the contraction in the money supply since the end of July, it appears that the turnover of money leveled off or declined moderately. With inventory cutbacks, layoffs, and other adjustments resulting from the strike, it is not surprising that the flow of expenditures would fall relative to cash balances. Turnover of demand deposits (except inter-bank and U.S. Government) at reporting banks outside the seven large financial centers decreased from a rate of 25.1 times per year in June and July to about 24.7 times per year in August, September, and October.

A reduction in the money supply is usually a restraining influence on economic activity. However, in view of the fact that the productive capacity of the country has been materially reduced as a result of the steel strike, it does not appear that a modest reduction in the monetary stock has been restrictive, even when accompanied by a slightly lower rate of turnover. The strike has inactivated for a time a significant portion of our productive capacity, and, therefore, it takes a smaller flow of spending to purchase the available output.

Reduced business activity because of a strike may have materially different implications for monetary policy than when business activity turns down in a recession. In a business recession, there is idle capac-

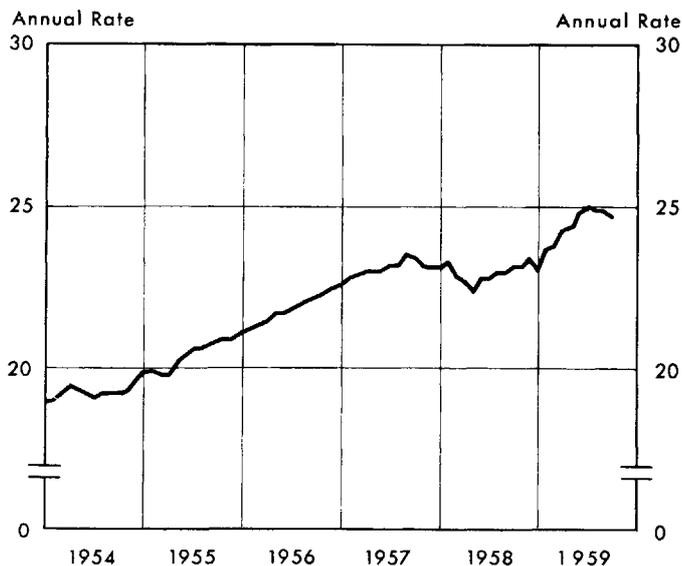
ity which is ready to produce if there is a demand for the products. Under these conditions it is generally believed that the money supply should be expanded in order to stimulate demand. In a strike, on the other hand, the capacity which has been shut down is not likely to be brought into production by an increased desire for the products.

In judging whether or not the size of the money supply is appropriate during a strike, the effect of strike-induced changes on the Government's fiscal actions should be considered. A major strike, like a business recession, brings about unemployment and lower income. Thus, during the strike, as in a recession, the progressive tax structure, provisions for unemployment compensation, and other so-called automatic stabilizers change the relationship of Governmental receipts to expenditures. As corporate and individual incomes decline, tax receipts fall, and as the impact of the strike spreads to additional firms, unemployment compensation payments rise. Hence, Government expenditures tend to increase relative to receipts.

In business recessions the stimulating effects of these automatic devices are widely praised because they tend to stabilize activity and they take effect quickly without the need for overt action. During a strike, when business activity in the nonaffected areas is at a high level, the automatic stabilizers also come into play, but since a greater demand for goods probably will not bring forth significantly more production, bidding may be increased for available goods causing their prices to rise. Hence, the so-called automatic stabilizers (both Government and non-Government) may have a temporary perverse effect on economic stability during a strike.

Turnover of Demand Deposits

Reporting Centers (outside seven large financial cities)



Latest data plotted: September.

Three-month moving averages of seasonally adjusted data.

Source: Board of Governors of the Federal Reserve System.

Conclusion

Bank credit and the money supply have declined at a time when the velocity of money has been slowing. However, because of work stoppages resulting from the strike a smaller money supply may not be more restrictive. With less productive capacity available for supplying the economy with goods and services, a flow of spending which was suitable before the enforced economic contraction may be inflationary during it. Then, too, because the shutdowns are apt to cause a reduction in Governmental tax receipts and an increase in Governmental outlays which tend to have an expansionary effect on activity, a smaller money supply may be appropriate.

Financial Security and Price Stability

ONE OF THE GREAT DRIVES of social reform of the past generation has been for financial security. To protect against economic uncertainty, individuals have sought steady jobs, joined pension plans, built up savings balances, and accumulated a large volume of other claims to dollar assets. It would indeed be a great irony if after the valiant efforts to supply economic security by such elaborate devices much of the benefits were to atrophy from dollar depreciation.

Growth in Financial Claims

Arrangements have been made through Governmental machinery for a large portion of the population to receive social security benefits. At the end of 1958, there were about 110 million persons in the United States with social security wage credits, and assets in the Old-Age and Survivors Insurance Disability Trust Funds amounted to roughly \$25 billion. In addition, many employers and other organizations have established private pension plans, and billions of dollars have been amassed by these pension funds for future payments.

Assets of life insurance companies in the United States total about \$112 billion at the present time. The aggregate of all policies that are now in force in the country is about \$550 billion, as against about \$112 billion at the end of 1939. About three persons in four in the country are now participating in some form of insurance. People have invested in life insurance with a view that they or their beneficiaries will receive a measure of financial security through bene-

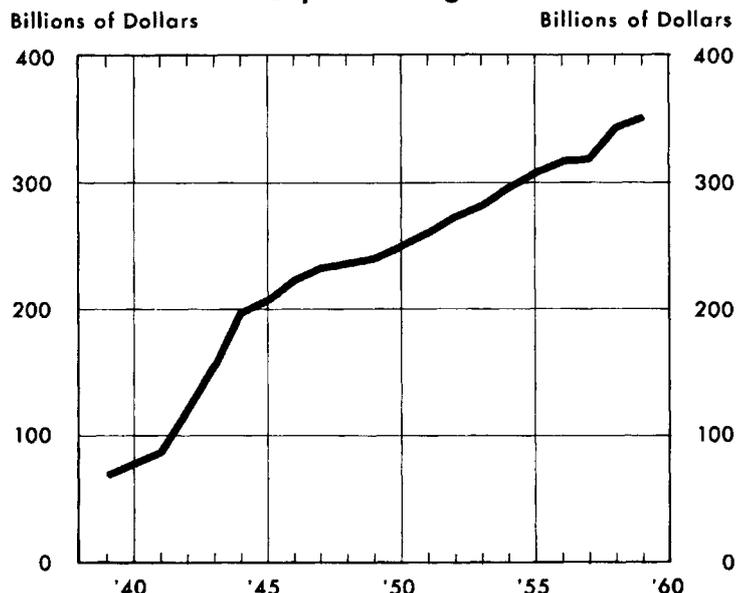
fits in the form of certain dollar payments in the future.

Also, the public has accumulated vast sums of money and other assets that are valued in terms of dollars. On June 30, 1959, the money supply of individuals and businesses totaled about \$140 billion of which \$111 billion was in the form of demand balances with banks and nearly \$29 billion was in currency and coin. At the same time the public had \$65 billion in time deposits in commercial banks, \$35 billion in mutual savings banks, and \$1 billion in the Postal Savings System. Share holdings in savings and loan associations amounted to \$51 billion, and investments in United States Savings bonds also totaled \$51 billion. In the aggregate these assets amounted to \$343 billion at mid-year, which compares with roughly \$70 billion at the end of 1939. A main reason for people accumulating substantial amounts of cash or items convertible to cash has been to provide financial security.

Likewise, there has been a huge buildup of other assets that will ultimately be returned in dollars. Examples are corporate, municipal, and marketable U.S. Government bonds, mortgages, and shares in credit unions. These investments were made with the expectation of obtaining a certain amount of purchasing power, not mere dollars as such.

A sizable proportion of the families of the country are dependent upon fixed or relatively fixed incomes. As retirement age is reached, if not before, most individuals of the country will be dependent upon fixed dollar payments.

Liquid Savings



Latest data plotted: 1959, estimated

Demand deposits adjusted and currency and coin outside banks; time deposits in commercial banks, in mutual savings banks, and in postal savings; U. S. Savings Bonds, and shares in savings and loan associations.

Source: Board of Governors of the Federal Reserve System.

Extent of Inflation

When people place their funds into fixed dollar instruments or assume obligations to provide services in the future for specified sums, they are interested in getting not just dollars but the ability to buy goods and services. For people who are providing for old age, sickness, or other periods of low current income, it is especially important that rights to future dollars maintain their purchasing power since these people will be getting fewer dollars per year than now, and accordingly, each dollar will be more valuable to them.

Despite the interest which the public at large has in avoiding declines in purchasing power of the dollar, there has been an almost steady erosion in the value of the monetary unit in recent years. As a result average consumer prices today are more than twice as high as they were in 1939 and about $\frac{1}{4}$ higher than they were in 1950. The increase has apparently not been halted. From March of this year to September, the consumer price index worked up at an annual rate of 2.4 per cent. Because of inflation during the six months the purchasing power of the money supply and savings in major institutions alone decreased approximately \$4 billion, an average drop in buying power of nearly \$25 dollars per man, woman, and child in the country.

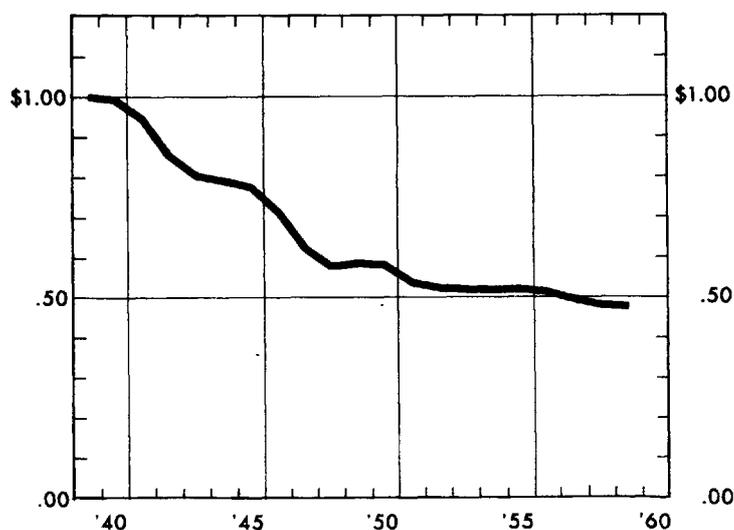
Some Steps to Stability

Fluctuations in individual prices may serve a desirable economic function by guiding resources into their most beneficial use. However, an overall rise in the price level means a reduction in the purchasing power of those with dollar assets. If the country is willing to discipline itself sufficiently, there is widespread agreement that the general level of prices can be kept from continually rising and that stability can be attained without resort to undesirable direct controls over prices and wages. Of course, differences of opinion may arise over which general measures to use and to what extent in order to accomplish price stability. But there appears to be little doubt that tax increases, cuts in Government spending, control of the size of the money supply, and similar measures can be made effective in halting inflation.

In general, inflation results when demands for goods and services exceed the amount that producers are willing and able to supply. Attempts to buy more bid prices upwards. Even when production is at less than 100 per cent of capacity, prices may work up if buyers seek a different product mix than is being supplied or if there is monopolistic pricing. In order to attain price stability actions must be taken which will equate demands for goods and services with the supplies available.

Value of the Dollar

In Terms of 1939 Consumer Prices



Latest data plotted: 1959, estimated

Source: Bureau of Labor Statistics. Inversion of Consumer Price Index computed by FRB, St. Louis.

One method of matching demands and supplies of goods and services is to vary the Government's fiscal policy. An increase in taxes tends to reduce demands for goods and services. Conversely, a rise in Governmental expenditures increases the amount taken. In the twelve months ending next June, it is estimated that the Government's cash receipts will approximately match its cash outlays. By contrast, in the last fiscal year there was a cash deficit amounting to about \$13 billion. A substantial cash deficit may have been desirable as an economic stimulant in early 1958 when the level of unemployment was comparatively high, but as capacity is approached in many lines a deficit tends to be inflationary. The shift from large net Governmental outlays to a balanced budget has reduced upward pressure on prices. By operating at a cash surplus, that is, collecting more taxes than expenditures, the Government could be even more anti-inflationary.

Another price stabilization weapon is to change the rate of growth in the money supply of the nation. With fewer dollars to satisfy liquidity requirements individuals and businesses tend to spend less; with a larger money supply demands for goods and services usually expand. From the last Wednesday of March 1959 to the last Wednesday of September the money supply of the country, seasonally adjusted, has been virtually unchanged. During the corresponding six months last year when economic conditions were relatively depressed the money supply was increased at an annual rate of 4 per cent.

Actions of businesses and labor in raising prices and wages may be inflationary. However, it is unlikely that many individual businessmen or workers will voluntarily forego additional profit or higher wages for the benefit of general price stability. Since others would not do likewise, an individual would be acting to his detriment. Besides, the profit motive is one of the strongest for stimulating growth in production and should be encouraged.

However, it is socially undesirable if businessmen or labor organizations by taking advantage of a monopolistic position set prices above the competitive level. Such actions, although adding to incomes of the price administrators (business firms or labor), reduce real national income and cause unemployment. The combination of monopolistic pricing, which withholds goods and services from the market, and national economic policies designed to maintain business activ-

ity at near capacity levels, sets the stage for continuous price increases. A reduction of the monopolistic influence, through such measures as anti-trust actions, removes an inflationary pressure.

Also, it might be noted that many struggles by business concerns or organized labor to raise profits or wages have had little effect on the real incomes of the owners or workers. For instance, an increase in money wages in one dispute frequently sets a pattern for other wage negotiations, and a general increase in the cost of labor is usually passed on in higher prices. Hence, bigger money wages and larger profits are frequently offset by a higher cost of living.

It has been argued that an increase in wages which is matched by a gain in productivity is not inflationary. Higher total wages in real terms must come primarily from greater production, and more output because of efforts of employees should be rewarded. But to insist that wages should rise as much as productivity in lines where improvement in output per man hour is relatively great because of capital improvements or technological advance may be inflationary. Better wages in the dynamic industries normally set the wage pattern for other firms, which meet the increased costs by raising prices. Attainment of general price stability requires that there be a decline in some individual prices in lines where productivity rises fastest. A more rapid rise in the general level of wages than the average increase in productivity tends to be inflationary.

Conclusion

During the past three decades a definite movement toward greater financial security has developed. There has been a tremendous buildup of savings balances and other dollar claims as individuals have sought to provide for their future. Probably never before in history has so large a proportion of the population had such a great stake in maintaining the purchasing power of the monetary unit. However, inflation has been eating away at the value of the dollar at an alarming rate.

In view of the great stake that people have in price stability and the general tools available to control the price level, it would seem to be a great irony to tolerate a further deterioration in the value of the monetary unit. Surely, the same public opinion which has caused the provisions for economic security will support a stable dollar in order to maintain that security.

Some Misconceptions in Public Understanding of Monetary Policy

THE RISE IN THE LEVEL of interest rates in recent years, and more particularly the sharp rise since mid-1958, has created considerable public interest in monetary policy.

Public reactions to Federal Reserve policies reflect sharp differences of opinion with respect to the forces raising interest rates and the principles guiding Federal Reserve authorities in this connection. Many people are generally aware of the reasons for current monetary policy and accept the rise in interest rates as the inevitable result of the bulging credit demands of a boom pressing against a supply of credit which is necessarily more limited in amount. There are others, however, who regard the rise in interest rates with alarm and resentment. They consider the present level of rates a product of an inappropriate monetary policy.

The generalizations most frequently used by critics of current monetary policy are the following:

1. Federal Reserve authorities are deliberately fixing interest rates at high levels.
2. Rising interest rates, by increasing the cost of borrowing, contribute to inflation.
3. Interest rates are abnormally high as evidenced by the fact that they are now at a 25-year peak.
4. Federal Reserve authorities have the power to keep rates down and should use that power.
5. Rising interest rates reflect a policy of excessive monetary restraint which inhibits economic growth and full utilization of resources.

The purpose of this article is to suggest that these generalizations in the main reflect (1) public misunderstanding of Federal Reserve policy and operations, and (2) preoccupation with immediate goals without sufficient regard for longer run consequences.

A Review of Federal Reserve Objectives and Controls

Since many of the above generalizations apparently reflect some basic misconceptions in the public's understanding of what the Federal Reserve authorities are attempting to do and how they are doing it, a brief review of the objectives and the mechanisms of credit control seems to be in order.¹

Objectives

The primary objective of the System is to influence the monetary and credit situation so as to encourage growth and resist both inflation and deflation.

The focal point of Federal Reserve action is the volume of member bank reserves available for lending and investing, since generally each new bank loan or investment, with its simultaneous creation of a new deposit balance, represents an addition to the money supply available for spending on goods and services.

In a boom period, the monetary authorities will attempt to influence member bank reserves so that the lending ability of commercial banks does not increase at a faster rate than is compatible with the economy's capacity to increase its real product. In other words, as expanding credit demands of the economy impose growing pressures on banks to extend more credit and to seek additional reserves to meet expanding reserve requirements, the Federal Reserve System strives to limit the increase in reserves and total bank credit to an amount compatible with sustainable economic growth without inflation.

Since interest rates are the prices paid for credit, it is not at all surprising that in the boom phase of our economy the strong credit demands of Federal Government, state and local governments, businesses and

¹For a more detailed description see Board of Governors, *The Federal Reserve System—Purposes and Functions* (Washington, D. C., 1954).

consumers generate an upward thrust in interest rates. The supply of credit, limited as it is by the volume of current savings, accumulated idle balances, and new commercial bank credit, does not and cannot keep pace with the virtually unlimited credit demands of a booming economy.

Instruments of Control

The Federal Reserve authorities have three major instruments for influencing member bank reserves and total bank credit—open market operations, discount policy, and changes in reserve requirements.

Open Market Operations—These are the transactions which increase or decrease Federal Reserve holdings of U. S. Government securities at the initiative of the System. Purchases of securities supply reserves to member banks. Sales of securities extinguish member bank reserves. These operations may be used not only to change the volume of bank reserves within the framework of a credit policy of ease or restraint, but also to offset losses or gains in reserves from changes in such factors as currency in circulation, gold stock, Treasury balances at Federal Reserve Banks, and float.

In view of the complexity of forces operating on member bank reserves and changes in the velocity of money, a period of monetary restraint may not necessarily be characterized by net sales of Government securities by the Federal Reserve. The System may find that it has to feed additional reserves into the banking system to offset the absorption of reserves caused by such factors as outflows of gold, increases in Treasury balances, or increases of money in circulation. In this situation the open market operations, although aimed at moderating the growth of commercial bank lending, will involve net purchases of securities to offset the losses of reserves mentioned above. It is also important to note that net purchases of Government securities by the Federal Reserve may be quite consistent with a policy of monetary restraint. Such a policy permits bank reserve growth compatible with a noninflationary expansion of bank credit.

The impact of Federal Reserve policy may be better judged by observing what happens to total bank reserves than by looking at purchases and sales of Government securities. Thus, the most powerful instrument of control, and the one that directly changes the total reserve positions of member banks, is understandably masked and quite likely to be ignored by the public.

Discount Policy—This relates to Federal Reserve Bank lending to member banks. The initiative in such credit extensions is taken by individual member banks when it is necessary for them to build up their reserve positions to required levels.

The discount mechanism, as now used, is largely complementary to actions in the open market. At a time of credit restraint, for example, open market operations furnish banks less reserves than they need to meet existing credit demands. The impact of such action is generalized for banks as a whole. Necessarily it hits some banks harder than others. Those individual banks which find their reserve positions especially hard hit in the process may borrow at the Federal Reserve Banks as they face prospective reserve deficiencies.

Borrowing by any individual bank is a temporary expedient to carry over until more fundamental changes in asset position can be effected. Under these circumstances the discount window operates as a safety valve, not to frustrate the impact of open market operations, but to permit that impact to be spread more evenly and smoothly over the banking system as a whole.

The member bank tradition against borrowing, in addition to Federal Reserve Bank policy on this matter, normally assures that the discount window is no more than a safety valve for individual banks. However, to guard against the use of the discount mechanism as a means of offsetting restraint through open market policy, the discount rate may have to be raised. If, during a period of credit tightness the discount rate is far below the market rate on Treasury bills, for example, banks find it more desirable from the cost standpoint to borrow at the Federal Reserve Bank than to sell off short-term Government securities. If the discount rate is raised to a level comparable to the market rates on short-term Government securities, individual banks facing reserve deficiencies may prefer to sell off their securities rather than borrow from the Federal Reserve, thus contributing to the intended tightness in the money markets and passing on the reserve pressure to other banks whose customers may buy the securities being sold.

It is important to emphasize that open market operations are the primary instrument of control and that the discount mechanism and the discount rate serve to re-enforce the intended impact of open market policies. More often than not the rise in the discount rate will follow the rise in market rates, reflecting the monetary tensions created by a bulging credit demand pressing against a supply of credit which has not been permitted to grow as fast as the credit demand.

Reserve Requirements—The Federal Reserve at its initiative may also diminish or enlarge the volume of funds which member banks have available for lending by raising or lowering reserve requirements. Unlike open market operations, reserve requirement

changes affect immediately and simultaneously all banks in each reserve class. It is a powerful instrument which has usually been employed only when large-scale changes in the country's available bank reserves are desired.

Since sharp changes in excess bank reserves are not desired in a period when the Federal Reserve is attempting only to moderate the growth of reserves, the System depends on open market operations and discount policies as the more sensitive and flexible instruments of credit control.

An Examination of the Criticisms of Monetary Policy

Does the Federal Reserve Deliberately Fix Interest Rates at a High Level?

The above review of the basic instruments influencing member bank lending makes clear that it is the lending ability of commercial banks and not the interest rate which is the major target of Federal Reserve credit policy. Unfortunately, from the point of view of public understanding of monetary policy, the most important credit control, namely open market operations, is the least dramatic and least likely to attract the attention of the public. What the public does see, however, is that in a period of rising interest rates the discount rate also rises. Observing no changes in legal reserve requirements and being unaware of the credit impact of open market operations, the public frequently jumps to the conclusion that the rising discount rate is *the* instrument and the *cause* of rising interest rates. In so doing they fail to realize that interest rates reflect the interaction of credit demand and supply forces and that the primary cause of the sharp rise in interest rates in 1959 has been the greatly expanding credit demands of a booming economy pressing against a growing but limited amount of credit. In this connection it is appropriate to point out that bank credit is only a portion of the total credit volume, and that an important limit on total credit availability is the volume of savings.

Are Interest Rates Abnormally High?

Often heard today is the statement that current monetary policy has raised the interest rate to the highest level in 25 years; that such a rise in rates is clearly abnormal and one that the monetary authorities can and should avoid.

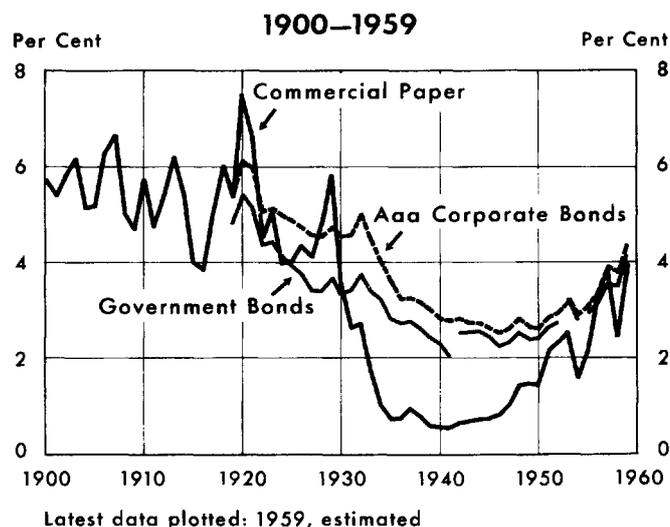
That interest rates are at their highest level since the early thirties is not to be denied. The implication, however, that the low levels of interest rates marking

the period from the thirties through the early 1950's constitute a "norm" is indeed suspect. Clearly, the depressed years of the thirties, with business flat on its back and credit demands at a low ebb, do not provide a basis for judging the rate structure of the present day, marked by tremendous credit demands of Federal, state, and local governments, businessmen, and consumers.

It is equally obvious that the low rates of the 1940's and the first year or two of the 1950's are not appropriate benchmarks for appraising the current level of rates. There we had a period in which monetary policy was subordinated to the policy of stabilizing the Government securities markets. That such a policy made virtually impossible effective control over commercial bank reserves, demand deposits, and the money supply appeared to be a consideration secondary to the prevailing fear that any upward movement in rates would bring a collapse of the bond market and perhaps "destroy public credit."

The most recent comparable period free from severe depression and war was that running from 1920 to 1930. Compared with the interest rates of that period, the current rates do not appear to be abnormally high, as some believe. During the first 5½ years after World War I yields on long-term Treasury obligations partly exempt from taxation ranged from 5% to 4¾ per cent. It may be recalled that that was also a time when the Federal budget was in balance and with the Government debt declining from \$26 billion to \$16 billion. During the entire 11-year period, the average yield on long-term Governments was slightly under 4¾ per cent (see chart).

Selected Interest Rates



Source: Board of Governors of the Federal Reserve System. Breaks in line for long-term Government bonds indicate changes in series.

Do Rising Interest Rates Raise Costs and Contribute to Inflation?

Much of the criticism of current monetary policy centers on the interest rate as a cost element confronting government at all levels, businessmen, and consumers. Impressive figures on mounting interest costs to government are intended to show that increased public expenditures and related inflationary pressures are directly attributable to rising interest rates. In short, the System's critics charge that monetary restraint, instead of holding back inflation, actually promotes it by permitting the rise in interest "costs."

There is a basic weakness in this position. The critics ignore the fact that rising costs attributable to advances in general price levels are much more substantial than those due to rising interest costs. For example, state and local purchases of goods and services are now four times what they were in 1946. It has been estimated that approximately one-half of this increase has been due to rising price levels since 1946, while the balance of increased expenditures stems from a growth in real state and local needs. Clearly, interest costs which reflect no more than 2 to 3 per cent of state and local budgets are not the important factors in the aggravated problems of state and local finance.

It is equally obvious that the cost of servicing the Federal public debt has not played the most important part in the mounting Federal expenditures, built up to a large degree by the sheer magnitude of national security needs and by the rise in prices in the years following World War II.

Although rising interest rates are relatively more important in mortgage financing, it is no less true that rising wage rates and higher building costs have played the dominant roles in determining the size of the mortgage that has to be financed.

The defenders of current monetary policy do not deny that interest rates are costs, and at times, painful to the borrower. They do insist, however, that rising interest rates merely reflect the tremendous market demand for credit pressing against a limited supply which, if expanded substantially in a boom period, would unleash a flow of spending and lead to a costly rise in prices far more painful and disruptive than the cost impact of interest rates.

Should the Federal Reserve Attempt to Hold Interest Rates Down?

Reflecting the feeling that interest rates are too high and that such rates as costs are contributing strongly to inflation, many have urged that the Federal Reserve Board authorize the buying of Govern-

ment bonds to support bond prices and thus restrain the rise in yields.

Here again those who support this proposal have failed to look at all aspects of this problem. They overlook the fact that to halt the upward trend of interest rates in this expanding period of our economy would require a tremendous volume of open market purchases of Government bonds. This could not be done without promoting inflation and, indeed, with out converting the Federal Reserve System into an engine of inflation.

As pointed out earlier, when the Federal Reserve purchases Government bonds, it increases the reserves of member banks, and thus their ability to make more loans, in an amount which is a multiple of the increase in excess reserves. Actually, each dollar of open market purchases of Government bonds by the Federal Reserve makes available about six dollars for additional loans or investments — a tremendous inflationary factor.

Most of us recall the difficulties involved when the Federal Reserve System pegged interest rates on Government obligations during and following World War II. The rates were held down, but a dangerous inflation developed under the blanket of direct price, wage, and materials controls, and when these wartime controls were removed the inflation broke out under the pressure of tremendous money demands on relatively scarce goods and services.

Even if the inflationary consequences were accepted, it is doubtful whether the Federal Reserve System could peg interest rates on Government obligations under normal peacetime conditions. The inflationary influence of such huge increases in credit would accelerate a further diversion of savings from investments in bonds and other fixed income obligations into stocks and other equities. It would lead to speculative buying of commodities and securities to beat higher costs and prices in the future. Thus, such efforts to stabilize interest rates would have a reverse effect and would push up interest rates in most sectors of the credit market.

Does Current Monetary Policy Inhibit Growth and Full Utilization of Resources?

Monetary policy critics frequently point to the existing volume of unemployment and the absence of supply shortages as evidence of an expansion potential that could be realized if monetary restraints were relaxed. Some critics broaden this position to include the general proposition that price stability as an objective of monetary policy is bound to inhibit growth and the full utilization of resources.

A noteworthy feature of this criticism of monetary policy is that it reflects a preoccupation with short-run objectives while ignoring the importance of long-run considerations governing Federal Reserve policy. If the sole objective of monetary policy is to be considered maximum employment and growth in the *short run*, the argument of monetary policy critics is plausible. If, however, the objective of economic society is orderly and sustainable growth over the *long run*, the defenders of monetary policy have some compelling arguments to submit in behalf of a monetary policy geared to the avoidance of longer run consequences of inflation and violent instability.

Unutilized Resources Not Evidence of Inhibited Growth—While the problem of unemployment is never to be minimized, the existence of unutilized resources in an expanding economy does not necessarily argue for additional injections of credit to support a higher money demand for goods. In this type of economy, expansion is cumulative—and at times explosive—increasing at rates that cannot possibly be sustained.

If the objective of society is growth at a sustainable rate, it is quite evident that monetary policy must at times moderate the bursts of expansion that would occur in the absence of some restraint. In other words, it is necessary to impose restraints on demand *before* it pushes on to the extreme limits of supply, if the economy is to avoid violent downturns in production and employment.

In this case, monetary restraint may be accompanied by an employment and output level lower for a time than that obtained in a high pressure economy with *no restraints*. In the long run, however, economic activity, although moderated in the short run by monetary restraints, can be expected to enjoy a more sustained and, averaging the boom years with the others, a higher rate. This is, of course, a long-run argument, and since it is always possible to get more out of an economy in the short run by running it at high speed, the advocates of less monetary restraint always appear to have a plausible case.

It is also significant that although unemployment in mid-1959 was substantial—approximately 5 per cent of the labor force—it was not generally distributed over the nation. A significant amount was concentrated in declining industries and distressed areas. Such unemployment does not respond quickly, if at all, to general increases in demand. Any attempt to remove such unemployment by large injections of new money would tend only to strengthen the inflationary pressures on those industries already strong and expanding with little impact on those industries such as coal mining, textiles, etc., which have been hit hard by

long-run shifts in demand and an uneconomic allocation of resources.

Creeping Inflation Not a Prerequisite of Long-Term Growth—The history of past relationships between prices and growth do not support such a claim. At some times in our history notably in the period 1875 to 1890, a declining price level accompanied an extraordinary rate of growth. It may also be of interest to point out that the greatest economic strides of any foreign country in recent years were made by West Germany with one of the best records of price level stability.

Critics of monetary restraint often point out that the upward price movement in the United States from 1933 to the present was accompanied by substantial growth. This is regarded as evidence that prolonged inflation is not as harmful as alleged.

Those who accept this as evidence overlook the important fact that during this period the price increases were not regarded as inevitable or as a continuing process. There was always the possibility that prices might decline.

The idea that inflation—a creeping inflation—is inevitable and necessary for growth is one that must be resisted by the monetary authorities for reasons well described in the following quotation:

The distortion of investment decisions, the discouragement of saving, the compulsion to speculate, the misallocation of resources, the strengthening of the monopoly position of firms owning old and low cost equipment—all are familiar dangers that have been pointed out many times. The inherent instability of an economy in which everything is worth what it is only because it is expected to be worth more next year; the fluctuations in the value of “inflation hedges” produced by the uncertain speed of the inflation; the need to concentrate all efforts on staying ahead of the game—all this does not add up to a satisfactory picture of a stable and rapidly growing economy. And, as the moralistically inclined may feel tempted to add, a society in which all contracts and financial promises are made with the afterthought that they will be partly cancelled by inflation, does not offer a morally-elevating picture either.

Few of the critics of inflation would claim that they can foresee its ultimate consequences. It may lead to collapse into deep depression, or simply to more inflation with stagnating growth. Or more likely, it will lead to price controls imposed under the pressure of impatient citizens and politicians. The immediate sacrifices that a policy of stable prices demands seem preferable to any of these.²

The rejection of creeping inflation as a matter of policy is a “must” if we are to avoid an economic situation in which every decision—whether by business, consumer, or government—is made in anticipation of rising prices.

² H. C. Wallich, “Postwar United States Monetary Policy Appraised,” *United States Monetary Policy* (The American Assembly, Columbia University, December 1958) p. 102.