The Federal Reserve's Role in the Economy*

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In meeting with your Association, I feel very much at home. Life insurance and central banking have many problems and many attitudes in common. We are both deeply concerned with long-term aims, with maintaining the strength of our economy and the strength of our currency.

Millions of Americans are putting their faith in life insurance for the protection of the future of their families, and this faith rests on the expectation that your policies will return to them a full measure of value for the dollars they are paying to you. These millions who entrust funds to you, and who rely on the Federal Reserve to safeguard the value of their money, want most of all safety and security—in your case, safety and security from want for their old age and for their families; in our case, safety and security from the twin dangers of inflation and deflation, the two deadly enemies of rational financial planning.

In trying to fulfill our duties, both your Association and the Federal Reserve System must rely on the best information and the most accurate analysis covering the innumerable factors that influence the development of our economy. It is therefore no coincidence that each of us has sponsored programs of basic economic research, and that the Federal Reserve has time and again benefited from the work of your Association. I may mention in particiular your invaluable studies in the fields of savings, capital markets, and interest rates.

I gladly take this opportunity to thank you for those contributions to our common efforts, and I can only hope that our research program proves as useful to you as yours has proved to us.

Now, if I may, I should like to make some observations on the Federal Reserve's role in our economy. I shall begin with recent developments.

Just a few days ago, the Federal Reserve raised discount rates to 4½ per cent, and the maximum rate payable on time deposits to 5½ per cent. The discount rate thus reached its highest level in more than thirty years, and the time deposit rate its highest level since the promulgation of Regulation Q, also more than thirty years ago.

In view of these developments, I would like to speak on three questions that I believe of interest to you: First, for what reasons and for what purpose did the Federal Reserve act? Second, does the action mean that the Federal Reserve disagrees with the rest of the Government on the basic issues of financial policy? And third, what is the significance of this action for the future?

First, I want to say that the Federal Reserve acted because it believed that the previous level of the discount rate and of time deposit rates was out of line with conditions in the money and credit markets and especially with the need to keep the flow of bank credit large enough to satisfy the needs of our expanding economy but not so large as to threaten to turn that expansion into an inflationary boom.

Second, the Federal Reserve acted not to hamper but to further the goal of the Administration—shared by the Congress and by the American people as a whole—to do the best that can be done to assure the continuance of our economic expansion, maintenance of generally stable prices, and restoration of reasonable equilibrium in our international payments.

And third, the Federal Reserve will continue to shape its policies with complete flexibility, firming whenever our further progress is threatened by inflation and easing whenever that threat has passed.

The Federal Reserve, in all its actions, aims always at the same goal: to help the economy move forward at the fastest sustainable pace. We reach our destination most rapidly as well as most assuredly when we travel at maximum *safe* speed—and this speed cannot be the same under all conditions and at all times.

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Actually, the recent increase in rates is intended not to reduce the pace of the economy's expansion but to moderate mounting demands for bank credit that might jeopardize that pace by overstimulating the economy.

A brief review of developments over the past twelve months in the three critical sectors of production and employment, the balance of payments, and prices will provide background for our recent action.

The production and employment record of our economy has been excellent. Our industrial output will be at least 7 per cent higher this year than in 1964, a significant gain by any standard. Employment has expanded fast enough to reduce the unemployment rate by a full percentage point since October 1964. For the first time since 1957 it seems likely that we may soon reach our interim goal of pushing unemployment down to, if not below, 4 per cent of our labor force. And despite such progress, average wages of production workers do not seem on balance to have risen faster than productivity so that labor costs per unit of output in manufacturing have remained virtually unchanged. The American worker—with whose progress all of us are concerned—has shown great responsibility in negotiating wage settlements that help to insure a steady rise in the real incomes of all Americans.

Our record on international payments balance is fair enough, but less satisfactory than in the field of production and employment. Over the first three quarters of the year, our deficit on so-called "regular transactions" was at an annual rate of $1¾ billion—far smaller than in any calendar year since 1957 but still far too large for comfort. We need to do much better if we are to reach our goal of reasonable payments equilibrium next year, and especially if we wish to do so without further interference with the freedom of international transactions.

But in the third critical area, maintenance of general price stability, our record has not been so good as in other recent years. Whenever in recent years our economic growth was less rapid and our payments deficit larger than we would have wished, we could be hopeful because our price level had remained stable. For we knew that such stability was a firm basis for further economic expansion as well as for further progress toward payments balance. But over little more than twelve months, the crucial index of industrial wholesale prices has risen about 1¾ per cent, after four years of virtual stability.

It is quite true that prices have not broken out of the pattern of modest and selective advance in recent months. In order to avert such an eventuality, the Government has taken action relating to prices of a number of individual key commodities. But selective intervention to deal with price pressures necessarily has limits. In the longer run, it would be ineffective if not accompanied by measures that affect the source of price pressures rather than the prices themselves.

Unlike price pressures during the period before 1958, recent price developments cannot be explained by cost-push influences. As mentioned before, unit labor costs have remained essentially stable. Such price pressures as are making themselves felt must be primarily attributed to demand-pull.

This fact should not cause surprise. The closer an economy comes to full employment of manpower and capital resources, the greater is the risk that bottlenecks will develop in strategic areas so that large new injections of bank credit and money will serve to raise prices more than production.

Whatever divergent views the experts may take in regard to the ability of a central bank to control price pressures generated by cost-push, nobody has ever denied that it is the function of monetary policy to restrain price pressures that originate from private demand. Hence, the threat to continued maintenance of the noteworthy price stability of the first four years of the present business expansion must be of concern to the Federal Reserve.

I do not want to imply that monetary policy had ignored the problem before last weekend. Since December 1964, the free reserves position of member banks has changed from a moderate plus to a moderate minus—limiting the ability of banks to increase their credit creation. The interplay between that degree of restraint and the accelerating pace of economic expansion led in many —though not all—financial markets to increases in interest rates, well before the recent rise in discount and time deposit rates. But let us not overlook the fact that, despite such restraint, commercial and industrial bank loans have increased this year by about 20 per cent.

As long as unemployment of manpower and plant capacity was greater than could be considered acceptable or normal, we had every reason to lean on the side of monetary stimulus. While this posture did risk some spill-over of funds abroad, the adverse effect on our payments balance was more than offset by the benefit to our domestic economic growth. And we have tried to combat excessive capital outflows by selective fiscal and monetary measures, including the voluntary foreign credit restraint efforts of our financial institutions in which the members of your Association have so magnificently joined.

But despite the exemplary compliance of the financial community, and the dramatic decline in the foreign credits of financial institutions, foreign investments of nonfinancial corporations were large enough to explain the persistence of our international payments deficit. As financial institutions reduced drastically the availability of dollar credits abroad, and thus had more funds to devote to domestic uses, their domestic customers were in a position to use part of the newly available funds to finance their ventures abroad. This is an example of the leakage inherent in selective credit controls, an indication of their limited effectiveness, and a demonstration of why they can only serve as stopgaps rather than lasting remedies.

Our closer approach to a satisfactory level of domestic output and employment has diminished the weight of the arguments against the use of general rather than selective measures to help counter price pressures at home as well as to help correct our payments imbalance. Obviously, no one, and least of all those of us responsible for monetary policy, would ever want to do anything that could undercut the sustained progress of the economy. But those who are fearful of the economic consequences of *any* move even toward the mildest restraint—any drop of free reserves below zero, any slight rise in interest rates—would do well to consider the record of the economy's performance over the past twelve months.

Let none of us overlook the fundamental difference between a change in interest rates *imposed* by a central bank *contrary* to the trend of basic economic forces, and a change *permitted* by the central bank *in line with* those forces.

If the Federal Reserve had followed the advice offered by some and had tried to force interest rates up at a time when the demand for investable funds (even at existing relatively low rates) was not sufficient to employ our idle resources and to move our economy rapidly toward fuller employment, such a policy would indeed have harmed our domestic economy, and in consequence the economy of the entire Free World. Conversely, if the Federal Reserve had strained to keep interest rates from rising by providing reserves without limit at a time when funds borrowed from banks were beginning to generate an aggregate demand in excess of output from available resources, the Federal Reserve would again have become, in the words of one of my distinguished predecessors, a veritable engine of inflation.

Recent developments in our economy—mounting danger of price pressures, rapidly climbing bank credit, and continuing deficit in our payments balance—have been warning signals. And they have indicated that prevailing market rates of interest were beginning to distort the flow of funds through the economy. Our recent action has been designed to insure that the demands for credit do not reach inflationary dimensions, and at the same time that the flow of savings remains sufficient to sustain, and be efficiently directed to sustaining, the economy's growth.

I realize that judgments can differ, not only as to the substance of an action, but also as to its timing. To me, the effective time to act against inflationary pressures is when they are in the development stage—before they have become full-blown and the damage has been done. Precautionary measures are more likely to be effective than remedial action: the old proverb that an ounce of prevention is worth a pound of cure applies to monetary policy as well as to anything else. It is simpler, for one thing, to try to prevent prices from rising than to attempt to roll them back. And finally, it is surer and safer: so long as inflation is merely a threat rather than a reality, it is enough to prevent the pace of economic expansion from accelerating dangerously. But once that pace has become unsustainably fast, then it becomes necessary to reduce the speed, and once such a reduction is started, there is no assurance it can be stopped in time to avoid an actual downswing.

This is no mere theoretical reasoning. It has been the practical experience of other industrial countries in recent years. Those countries that permitted inflationary trends to take firm hold have been forced to institute harsh remedial measures to restore stability, and invariably they have had to pay the price of actual reduction in output and real income. We shall succeed in avoiding a "stop-and-go" cycle—as the British call the practice of first permitting inflationary pressures to develop and then taking drastic measures to suppress them—only if we do not delay until inflation is upon us.

One curious concern voiced in the press is that our action might hamper the Administration in its efforts to introduce a "tough" budget next year. Nonsense. I have every confidence that the President will come up with a budget for fiscal 1967 just as "tough" as the necessities of the war in Vietnam permit. It is monetary policy that must adapt itself to the hard facts of the budget—and not the other way 'round.

Now I'd like to add something about our increase in maximum rates on time deposits. This part of the action was designed to permit the banking system as a whole, and the smaller banks in particular, to expand their resources sufficiently to provide the economy with additional credit, especially medium- and long-term accommodation.

In recent weeks, the rates paid by the largest banks on certificates of deposits had been "bumping" against the previous ceiling of 4½ per cent. This situation not only made it difficult for those banks to add to their resources; more important, it made it virtually impossible for the smaller banks to add to theirs, since these banks have to pay some premium in order to attract new depositors in competition with the giants.

Let me emphasize that the new rate sets a maximum, not a standard. We expect banks, both large and small, to exercise a high degree of prudence and responsibility in their use of this increased rate flexibility. If they do, there now will be room for smaller banks to attract funds by paying slightly higher rates than the big ones. This opportunity for smaller banks to compete more effectively is both economically advisable and socially equitable. It makes for a better regional distribution of the availability of funds throughout the country; and it makes for a larger flow of funds to small business, which is mainly dependent on the smaller banks for their credit accommodation.

The Board of Governors has purposely refrained from raising the maximum rate for savings deposits. It has done so in order to minimize the impact on competitive relationships between commercial banks and savings banks and savings and loan associations, which depend for their resources mainly on funds deposited by individual savers rather than by corporations. I expect a continued ample flow of funds into residential construction.

I hope this discussion will add to understanding of the reasons and the purposes of our action. But what about its relation to the basic financial policies of the United States?

The Administration has—rightly, in my judgment—stated time and again that its goal was the most rapid economic progress compatible with price stability and payments equilibrium. And the Administration—no less than the Board of Governors of the Federal Reserve System—has recognized, by deeds as well as by words, that the dangers of spreading price increases and persisting payments deficits are the primary threats to the achievement of that goal.

In the monetary sphere, no less than in others, the making of decisions—on the direction of operations, on the precise timing of actions, and on the precise choice to be made among the instruments of policy available—is often difficult, but the necessity of making these decisions is inescapable.

And in the monetary sphere, the Federal Reserve Act imposes the responsibility—as well as the authority—for making decisions upon the Board of Governors and the Federal Open Market Committee. In the discharge of our responsibility, and in the exercise of our authority, we must—and we do—give careful consideration to the opinions and judgments of others who also bear grave responsibilities. But the use of the authority assigned to us cannot be delegated, nor can the responsibility we bear be escaped. To promote effectiveness and to avoid inconsistencies, we will always endeavor, to the best of our abilities, to coordinate our moves with those of other agencies in seeking to achieve the common goals of economic policy. But we cannot take monetary measures that are contrary to our best judgment, or refrain from taking measures that we consider necessary.

As I have said many times, the American people, through the legislative process, can change the authority and responsibility of the Federal Reserve System whenever they choose to do so. But unless and until the law is changed, I should consider it a violation of my oath of office to vote for or against a policy measure for any reason other than my best judgment of that measure on its merits.

Now, in conclusion, a few words about the third question, concerning the significance of our recent action for the future.

I cannot repeat often enough that the main requirement of monetary policy is flexibility, the capacity for adaptation to changes in the economy as they develop. This is particularly true for monetary policy in times of prosperity. Whenever the economy approaches full employment, the central bank must be constantly on guard against two opposite dangers that threaten continued expansion: not only against the risk of orderly growth giving way to an unsustainable boom, but just as much, if not more so, against the risk of an upswing leveling-off and giving way to stagnation or downturn. The Federal Reserve is not looking only at those data that seem to be warning of inflationary pressures. It is also scanning the horizon just as carefully for indications of weakness in the economy wherever it may be found—in residential construction, in inventories, in employment, or in any other sector.

Moreover, monetary policy will always need to take into consideration other Government policies and especially fiscal policies. Obviously, it will make a great difference for the development of interest rates, of monetary and credit conditions in general, and thus for the posture of monetary policy, whether the Treasury will need to divert more funds from the private capital and credit market than last year or whether, on the contrary, it will be able to reduce its borrowing. Even if we knew how the private economy would develop next year, we could not know whether any action that might be needed would be taken in the fiscal sector or whether the main burden of policy action would fall on the Federal Reserve.

For these reasons, I hope you will understand that neither I nor anybody else can predict whether, in the future, conditions will be such as to require greater firmness or greater ease, or for that matter a policy of neutrality.

There is only one thing I can predict and promise. The Federal Reserve will do its utmost, within the limits of its powers, to maintain a solid monetary and credit foundation on which to build the economy's continued progress.