THE FEDERAL RESERVE SYSTEM AND ECONOMIC STABILITY

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Governor C. Canby Balderston, Vice Chairman, Board of Governors, of the Federal Reserve System, was born in Kennett Square, Pennsylvania, 1 February 1897. He has been awarded the following degrees: B.S. in Economics, University of Pennsylvania, 1921; A.M., 1923; Ph.D., 1928; and LL.D. (Hon.), 1955. During 1925-31 he was assistant professor of industry at the University of Pennsylvania and from 1931 to 1954, professor. From 1941 to 1954 he was dean of the Wharton School of Finance and Commerce. From 1942 to 1945 he was chief of the War Department Wage Administration Agency, and of the Wage Administration Section, Headquarters Army Service Forces. From 1943 to 1953 he served on the Board of Directors of the Federal Reserve Bank of Philadelphia and was deputy chairman from 1949 to 1953; member, Board of Governors, Federal Reserve System since 1954, Vice Chairman since 1955. He is the author of many books on profit sharing, group incentives, industrial relations, and wage setting, and co-author of several books on management. He was presented the Exceptional Civilian Service Award by the War Department in 1944. This is his second lecture at the Industrial College.

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GENERAL QUILL: Admiral Rose, Gentlemen: During this unit of instruction we frequently, in our examination of the various control measures for stabilization, make reference to a very important agency, our Federal Reserve System. We made reference to it yesterday in our discussion by Mr. Roosa from the Treasury, and you will recall that last September, in the Basic Economics Course, we studied the organization and operating methods of the Federal Reserve System.

This morning we shall take a closer look at the operations of the System, from the policy level. We are honored to have, as our speaker today, a man who has helped shape the policies of the Federal Reserve System, as a Member of the Board of Governors since 1954, and Vice Chairman of the Board since 1955. In addition you will have noted from his biography that throughout his entire career he has been intimately associated with the world of monetary and fiscal affairs.

At this time I am privileged to present for his second lecture at the College, Governor C. Canby Balderston, who will speak on "The Federal Reserve System and Economic Stability." Mr. Balderston.

MR. BALDERSTON: Admiral Rose, Gentlemen: My talk will cover the following points: (1) direct control of materials, prices and wages, and selective control over credit; (2) general financial controls, both monetary and fiscal; (3) differences in the impact of monetary and fiscal policy; (4) the adverse balance of payments.

During World War II, selective controls over credit were employed along with direct controls over materials, prices, and wages. Again, during the Korean war, along with the revival of direct controls that we associate with the rationing family, the regulation of consumer installment loans was reimposed to restrict the purchase of consumer durables such as autos and radios. The administrative difficulties growing out of the imposition of such detailed regulation may be visualized when you remember that regulation W applied to 200, 000 retail firms.

Unfortunately, not all of these were imbued with the patriotic fervor to make such regulation automatic.

Although selective credit control did help to dam up consumer demands during the Great War, it did not prevent an eventual outburst of prices once the war was over and the controls were removed. Since World War II, nations have shaken off such controls. By the end of 1958 the progress achieved toward currency convertibility by Britain and by the Western European nations meant that for all practical purposes it was an accomplished fact. For importers to be able to pay in currencies of their own countries for goods that they had bought, was obviously a boon to international trade.

That year of 1958 may have marked the turning point in the economic affairs of our country. Not only did currency convertibility come over the horizon at the end of that year making it possible for funds to flow from one financial capital to another, but it was at about that time that we ceased being the sole large lender of funds in the post-war world and started to become a borrower. And so, at Vienna, in the negotiations of last fall we were not telling them anymore, we were asking. And the final decision as to the terms under which we could borrow from the fund depended upon the thinking and the good will of countries like France, Germany, and Italy. The discarding of wartime controls in favor of general controls, both fiscal and monetary, marked a return to free enterprise and to the decentralized decision making that it permits; a very fundamental point.

I remember an observation about Hitler Germany, that the decision making had been so centralized by Hitler that the only mistakes he could make were major ones. The freedom to make private economic decisions is a vital part of our system of economic and governmental organization. It is essential to the freedom of the individual. But freedom can be preserved only so long as it is accompanied by wisdom and restraint. Each time we elect to spend we should consider how the bill will be paid. To me, a lesson that we have not yet learned in this country, is that without borrowing abroad a nation cannot spend and lend more than it earns through production.

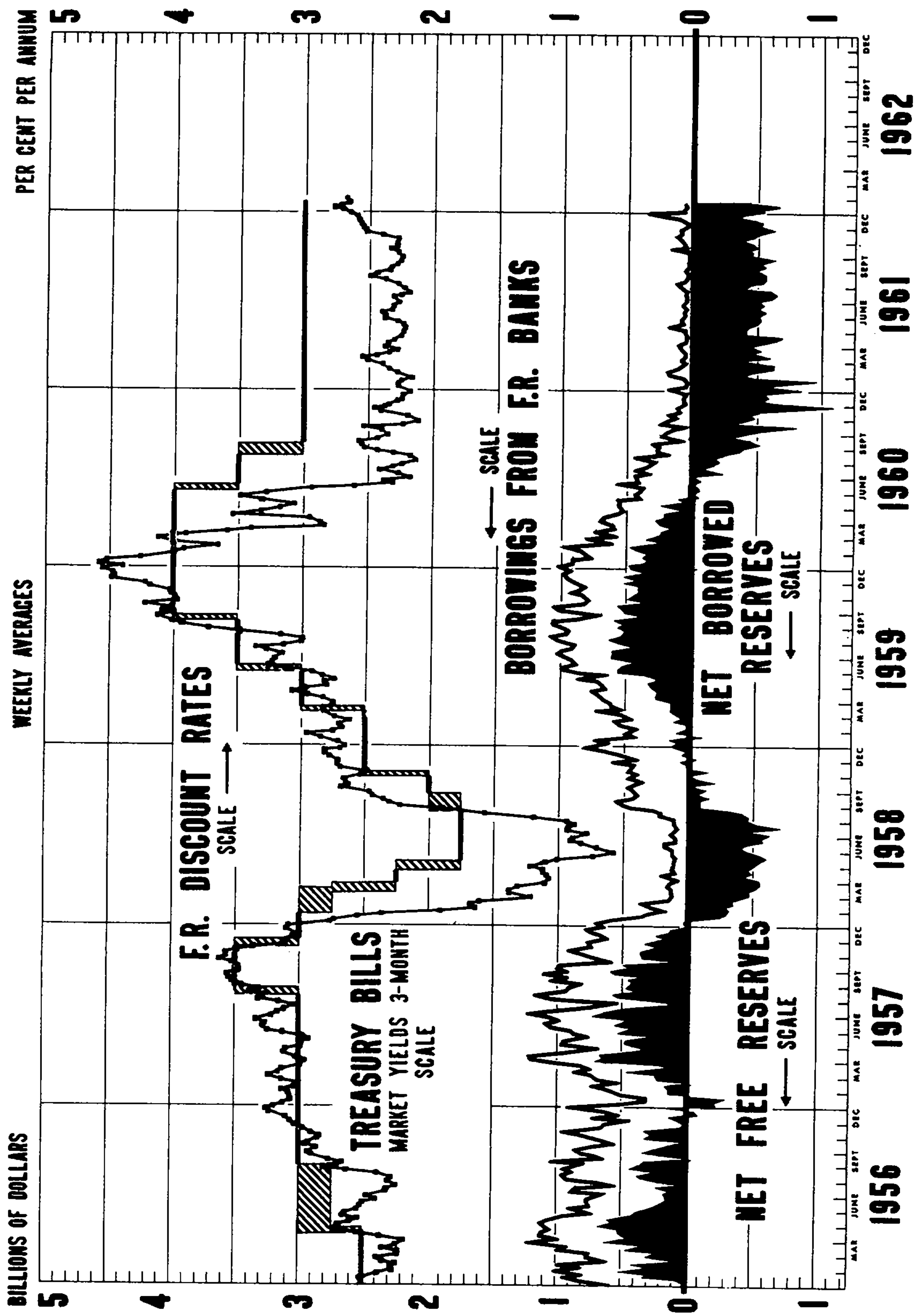
Goods consumed have to be produced by someone's sweat and investment supported by someone's savings. The role of monetary policy, as distinct from fiscal policy, is to regulate the reserves available to commercial banks, so as to promote economic growth, high levels of employment, and reasonable stability of prices. It is this responsibility, so vital to the protection of the integrity of the dollar, that has been delegated by the Congress to the Federal Reserve. That is our primary job. Yet, the Federal Reserve regulates money and credit only as to their total supply; not as to their allocation among firms and individuals. Sucb allocation is left to the competitive forces of the market except where Congress intervenes through taxes, appropriations, or governmental guarantees. This is quite in contrast to the procedure in many countries where the central bank intervenes in the allocation of credit to agriculture, to exporters, etc.

Thus, in the main, decentralized decision making of individual borrowers and lenders determines the use of our economy's resources. The great value of monetary policy as a contracyclical device is its flexibility. This flexibility makes the timing of monetary actions more precise and manageable than is the case with fiscal policy. The chart on page 4, which I will be discussing a little later, shows without careful examination at all, what I mean by a flexible monetary policy. The first impression you get from that chart is one of movement, of flexibility.

Now, fiscal policy, which is the Treasury's job--the job of Secretary Dillon and Under Secretary Roosa--embraces debt management, Federal spending and taxing. Although in the long run it may prove more potent in helping promote economic growth and stability than is monetary policy, inability to time its impact makes difficult its effective implementation to combat cyclical variations. It may be said that our present fiscal structure possesses tremendous countercyclical automaticity with substantial deficits developing even in mild recessions and disappearing with recovery.

Yet, any more delicate adjustment to combat cyclical movements through changes in governmental spending and taxing is difficult. The impact is so delayed that stimulation is likely to be felt after the private sector has already recovered. The result, then, is to pyramid demands to the point where resources, human and other, are placed under strain, and of course prices are pushed upward. For example, the congressional appropriations of 1958, whose effects were intended to be contracyclical, actually accentuated the boom in the private sector of the economy a year later, even though the anticipation of Federal spending may have shortened the decline that came to an end in April 1958.

TREASURY BILL RATE, MEMBER BANK BORROWINGS AND FREE RESERVES



Moreover, this governmental spending in excess of receipts forced the Treasury to have to borrow $11 billion net in the capital markets during 1959. This competition for savings with private industry and with State and municipal governments forced interest rates to peak levels at the end of that year. You recall the "magic fives" issued by the Treasury at that time. Well, they marked the high level to which interest rates were pushed. United States interest rates then were at the highest level in 30 years. The efficient flow of funds from savers to borrowers directly and through intermediaries does not come about without a price. Somehow this lesson gets forgotten by our people.

This price, the rate of interest, represents a penalty to those who use someone else's money and a reward to those who save and risk their funds on loans on investments. The six-year record of short-term interest rates and of flexible monetary policy are portrayed by the chart. If you will look at the line at the top you will see how the Treasury bills responded to the greater availability of reserves in the spring of 1958. The Federal Reserve was then fighting the recession that ended in April, making money available so that bank credit might expand, and the bill rate responded by going down to five-eighths of 1 percent. It went through the floor. I would like to live that year over again because it seems to me that that brought side effects like some medicines are said to do, that were unfortunate. I refer to the fluctuations in the bond market of that year that induced speculators to operate in Government bonds. Some made money, and some did not.

Now, in the last year and a half you will notice that the Treasury bill rate--I refer here to the rate of 91-day bills--has remained fairly stable between 2.25 and 2.5 percent. That has been brought about through the cooperative efforts of the Treasury in keeping up the supply of bills offered to the market--and the Federal Reserve, in trying to keep the rate from being pushed downward by its own operations. A cooperative effort between the Treasury and the Federal Reserve has helped on the supply side.

Now, on the demand side, despite the heavy buying of bills by the commercial banks, corporate treasurers have found other outlets for corporate funds, like RP's--that is, repurchase arrangements--placing funds in London and other foreign countries. And the demand that you might have expected from the corporate sector has been somewhat diminished thereby. Anyhow, through the help of circumstance and intended policy, bill rates have remained fairly stable for a year and a half, in response to the need, which I will be discussing later, to avoid too large a rate differential between this country and other countries.

The lower half of the chart, from the borrowing line down, reflects in the simplest form I can give you, the operations of the Federal Reserve--the monetary policy actions. You will notice the top line reflects the borrowings that commercial and member banks make from the 12 Federal Reserve banks. In times when money is less easy, those borrowings have reached $1 billion, or slightly over. During this last year they have been running at only $50 to $75 million. The white area between the line that portrays the borrowings, and the jagged area--that white interval or distance represents the excess reserves of the member banks. Usually, this excess runs somewhere around a half billion dollars, most of it in the country banks. Sometimes it will get up to $600 million, but it ordinarily is fairly constant at around a half billion.

This excess is the difference between the reserves made available by the Federal Reserve and those required to be kept by the commercial banks based on their deposits at the moment. They must keep--if they are big banks in the cities--16.5 percent of their demand deposits and 5 percent of their time deposits. In the country banks the figures are 12 and 5 percent. Those are their required reserves. And that white area represents the excess between that requirement and what the Federal Reserve makes available.

Now, when the borrowings from the Federal Reserve are high, as they were in 1959, and larger than the excess reserves, then there is what we call "net borrowed reserve" shown by the arrow. During such an interval commercial banks are under some pressure, both from the Federal Reserve and from their own banking tradition, to reduce their indebtedness to the central bank, which, here as in other countries, is the bank of last resort. Conversely, when borrowings from the Federal Reserve are small, as they have been recently, and banks have net free reserves shown by the black areas, banks seek lending opportunities more avidly and interest rates tend to decline or to stay low. This explains the near record expansion of bank credit, which is not shown on the chart, during this past year--1961. Bank credit rose in that year by nearly $15 billion, or 7.5 percent.

Now I turn to recent shifts in emphasis in the management of the monetary and fiscal affairs of our country. Other industrialized nations such as Great Britain have long recognized the necessity of maintaining international equilibrium in their balance of payments. But in the United States the problem was different, because this country held the major portion of the gold stock of the Western World and also possessed the productive capacity to reequip the devastated nations. So, until 1958--that turning point--the United States was concerned about a problem diametrically opposite to our present international worry. The two wars had so dissipated the productive capacities of industrialized nations and their financial stability as to create a dollar gap.

You remember all the articles written about the dollar gap and how it inhibited our exporting. Well, the war-torn countries, though they needed our exports of material and American-made equipment to rebuild their economies, did not have the dollars with which to pay for them. The problem of the United States at that time was to make our allies and former enemies into viable customers again. We sought to bridge the dollar gap through private investments in and governmental loans and guarantees to these countries. So well did we succeed with the Marshall plan that it is recognized as a signal success. By the late 1950's the other industrialized countries had rebuilt their manufacturing plants and improved their management techniques so greatly that they were not only in a position to supply more of their rapidly growing domestic demands, but to compete vigorously for the export markets of the world.

One effect of the emergence of new productive capacity here and abroad is downward pressure upon the prices of such physical goods as move in world trade. Our firms have begun to appreciate that excess productive capacity is a powerful brake upon price advances. No longer can they float off the effects of imprudent wage-setting in the form of higher prices, because new choices have been opened up to the consumer in the form of alternative sources and substitute products. Steel is not immune to the competition of aluminum, etc. Gradually the idea that an upward price-drift is inevitable has been dissipated as wholesale prices have moved slightly downward.

The disappearance, for the time at least, of the expectation of price inflation has permitted the Federal Reserve to continue to foster the expansion of bank credit in a way that would not have been prudent for our country if price advances had stimulated inventory-building and other forms of speculative ebullience. You will see that from the black area in the lower right-hand corner of the chart. Although the removal of direct and selective controls by other countries as they recovered from the damages of war was a great advance for them and for world trade in general, it created fresh problems and challenges for the United States. Once the currencies of leading countries became convertible, funds could flow from one financial capital to another with alacrity. Their movement was impelled by such forces as interest-rate differentials and speculation. And so this basic change has caused our fiscal and monetary policymaking to reflect the need to maintain world confidence in the integrity of the dollar. Serving as a reserve currency and therefore as an alternative to gold, the dollar plays such a vital role in lubricating international trade that loss of confidence in it would be damaging both to the Western World as a whole and to the United States. An adverse balance of payments means to a foreign observer that our exporting is not large enough to pay for the investing, lending, and spending that our Government and its citizens do abroad, and that our industry is failing to attract the dollars that are available in the world.

The imperative need to improve our adverse balance of payments means that either the United States must have more help from the industrialized nations in carrying the military and economic burdens of the Western World, or our margin of exports over imports must be increased. Our country has had an adverse balance in each year since 1950 except for the one year of 1957. During each of the last four years the figure has been between \$3 and \$4 billion if one excludes prepayment of debt. The consequent accumulation of foreign claims upon our liquid dollar assets has increased especially fast when interest differentials induced American and foreign holders of funds to invest them elsewhere, or when speculators preferred to hold gold or some foreign currency instead of dollars, or some foreigner delayed debt repayment to an American firm in the expectation that the dollar would become cheaper. At times the outflow of gold was strong, as in 1958, when the figure reached \$2.3 billion; at other times, as in 1959, the outflow was small even though foreign claims continued to mount. Fortunately, our exports have been exceeding our imports by a healthy margin, thanks to the boom in Europe and Japan. But this sizable balance in our current accounts has not been sufficient to offset the outflow of private capital that has resulted from American investment abroad, and from the borrowing by foreigners from our American banks, plus our vast governmental expenditures and lending abroad.

Inducing other nations to assume a significant portion of the military expenses of the Western World, and of the capital needs of underdeveloped countries, is the task for our State and Defense Departments; it is beyond the compass of my discussion and so I shall turn to the other side of the equation, the increasing of our trade balance so that we can improve our ability to pay for our foreign investing, spending, and lending.

The essential point is that our exports must exceed our imports sufficiently to pay for our new investments abroad, plus the military expenditures of, say, \$2.5 billion, and economic aid across the seas that our world leadership seems to entail. This means products of the right design and quality offered at the right terms and prices. The prices that count are the export prices of the world and not the prices at home. It's important to encourage American inventiveness to create new products for the markets overseas. Our country is rich in resources and in management know-how. But how much it can invest, spend, and lend abroad depends basically on how much more it exports than it imports. This means that our firms must be competitive in the world's marketplaces, which are coldly realistic. Export markets have no emotional ties such as loyalty to keep customers wedded for long to American suppliers. Foreign customers are not interested in why an American firm fails to offer a better product at a lesser price than firms in some other countries. Nor can sentiment for long hold a domestic customer who can get a better bargain elsewhere.

It is time, therefore, to take stock of our wage-setting and pricing policies to the end that the prices quoted may promote the export trade needed to finance our country's obligations as a leader of the Western World. The problem is similar with respect to imports entering our markets. It cannot be solved by raising tariffs and other obstacles to free competition. Such devices do not cure the cost differentials that are the seat of our difficulties. Moreover, we cannot export freely if we do not import freely, because nations would erect retaliatory barriers and prevent us from achieving the trade surplus needed to finance our overseas activities.

I'm reminded of my friend who returned to London from the Middle East in the course of the blitz. As he walked along the street he saw a group trying to help at a house that had been knocked down by a bomb. By the time he arrived a little old lady emerged from the basement, and as she brushed herself off and rearranged her clothing she said to him, "These 'ere bombs sure take a body's mind off the war, don't they?"

What I'm suggesting is for the cold war, which seems destined to last a long while. These things that I'm talking about are the real fundamentals to the economic health and strength of our country. Dr. Arthur Burns was talking to the American Iron and Steel Institute last year and he gave them the following prescription which seems to me worth noting:

> Unless the government moves prudently in increasing the money supply and its own rate of spending; unless trade union officials keep their demands for wage increases from exceeding improvements in general productivity [notice he said "general productivity"] unless the government refrains from passing

laws that raise wages or prices; unless business firms and trade unions join in efforts to remove restrictive labor practices and the featherbedding in which both executives and workers sometimes indulge; unless the government reforms our tax system in the interest of stimulating greater effort, more productive investment and higher efficiency; unless businessmen innovate vigorously and lower prices whenever possible; unless these things are done and a liberal policy toward imports is continued, we will not avoid new and successive rounds of inflation.

To me, a more immediate threat is the risk that if these steps are not taken, funds will flow abroad that otherwise would seek investment at home and thereby help to create some jobs. This outcome would not be remedied, but worsened by an overly liberal fiscal policy and by too easy money. On the contrary, the task that faces our country involves hard thinking and hard decisions both for government and for business and labor. As Kenneth Boulding, the economist, has observed, "Without the heroic, man has no meaning; without the economic, he has no sense."

Thank you very much.

QUESTION: Governor Balderston, during the period of the dollar gap it seemed to make sense for us to loan money and grant money overseas to allow some other countries to afford our goods when they could not otherwise do it. What economic justification is there for continuing the aid program?

GOVERNOR BALDERSTON: Of course, we cannot cure the situation that I sketched by eliminating any single item from our expenditures. If we were to drop the aid program of, say, $3.5 or $4 billion we would--by just blue-penciling it--also effect our exports. So that, the solving of the problem is not a simple one that can be reached by deciding that something like military expenditures, if dropped, would be a complete solution, or that loans to underdeveloped countries would be a complete solution. I would think that for the long pull the United States could not remain an economic island in the midst of worldwide misery. That is a political dictum, I suppose. If it be true, then the faster we can develop and broaden world trade, the more chance we have of providing markets in countries now called "underdeveloped."

As we develop those markets, there will be exporting opportunities for us and for other countries of the Western World. On balance, I would suppose that the reasons are both political and economic, if you are talking about the long pull. Our problem, like that of the drunk, is to get from here to there. At the moment we are not earning enough to pay for the lending and the spending, and the private investing that we are doing abroad, and that is our problem as I see it.

The Western World as a whole must certainly supply these underdeveloped countries, or they will turn elsewhere. My own feeling is that, just as we have been putting $900 million a year into Germany, which is almost the precise amount by which German reserves have been mounting, so it is a helpful thing that Germany should now, following negotiations, be willing to do some of her military buying in our country. Now, if she, France, Holland, etc., would also take care of some of the long-term lending to some of the underdeveloped countries, that would lighten our burden. As you will notice, the practical problems are twofold. Number one, interest rates are higher abroad than they are in New York City, excepting in one country--Switzerland.

Number two, the countries like Switzerland, Germany, and Holland, do not have the highly developed financial market that we have in New York. And so, when the Bank of Japan needed to borrow last November, it of course went to New York and made arrangements with our three big American banks that have branches in Japan. That was the place where such arrangements could be worked out, because the financial market is established and going. And besides, the interest rates were lower in New York than in other parts of the world, excepting Switzerland. Now, if the same highly-developed arrangements can emerge in Western Europe, that would facilitate some of this long-term lending that I would like to see.

Your question is a hard one to answer because I cannot say to you drop the $3.5 or $4 billion that we are spending for underdeveloped countries and our problem would be solved. I do not think it would, economically, leaving out of account the obvious political problem.

QUESTION: You mentioned the 15.5 percent requirement for the city's Federal Reserve requirement. Have there been any changes in that since 1960? And also, would you explain the significance of the hatched area on this chart?

GOVERNOR BALDERSTON: The last changes that were made in reserve requirements were made in 1960 in an effort to supply reserves to offset the recession. Congress, in its act dealing with reserves, had stipulated that central Reserve banks, namely those in Chicago and New York, were no longer to be in a separate category. The reserve requirements for the banks in those two cities, therefore had to be brought down to the level of the banks in what used to be called "Reserve cities."

Also, Congress authorized the Federal Reserve to count vault cash. That is the cash that the banks keep on hand to take care of your check cashing, etc. It permitted us to count vault cash as part of the reserves. We asked Congress to permit that for two reasons. One, we thought it was only fair for banks geographically removed from our Federal Reserve banks to be able to count as reserves the vault cash that they have to keep on hand for the convenience of their customers. Second, we felt that as a civil defense measure something might be gained in the event of an atomic accident, if the currency of the country were distributed widely enough so that there would be no difficulty on account of large supplies of money being too hot to use. That has had some effect. And the vault cash kept by the country banks has increased both last year and the year before.

So much for the change in reserve requirements. We have not made changes since the year to which you refer--1960. In that year we made several.

As to the hatched area at the top of the chart, that means that some of the 12 Reserve banks changed their discount rates before others did. You see, there are 12 Reserve banks. Each of the 12 banks may recommend to the Board of Governors, changes in the discount rate of that particular district. The Board of Governors has the obligation to review and determine. If there are differences in the economic situation as between heavy industry districts like Cleveland, and agricultural districts like Kansas City and Atlanta, they tend to get reflected for a short time in differences in the discount rate. But, since we have a national market and funds can flow readily from one district to another by wire transfer, it does not take long for the situation to seem to call for a uniform rate.

The hatched areas do reflect that flexibility provided by the law.

QUESTION: Governor, do we know to what extent our aid programs, our foreign loans, and our military expenditures abroad, call for U. S. exports? In other words, do we know to what extent those, what we call "aid programs" do result in free dollars held by foreigners that can then be used to call out gold? What I am trying to get at is just how much do we have to increase our exports to cover the effects of the aid program?

GOVERNOR BALDERSTON: I would suppose that we know the answer to your question only in part. Harold Linder told you about the operations of Export-Import Bank yesterday. We are financing the export of things made in this country, and so parts of our lending are now tied to purchases made in this country. But where we do not know the answer, it seems to me, is where a loan without strings is made to a country like India.

India is free to buy wherever the prices seem best; perhaps Germany, perhaps England, perhaps in Switzerland; wherever it may be. If the loan that we make to such a country is used to buy in a third country, then obviously the supplier in that third country, be it Britain, Holland, Germany, or Switzerland, has dollars as a result. If he chooses not to hold those dollars he turns them in to his central bank for sterling, Swiss francs, or whatnot. Then that central bank, if it has a policy of drawing gold whenever its reserves get up to a certain level--if it has had that as a tradition or as a formal policy--the acquisition of dollars will tend to cause that central bank to buy gold, and an outflow from here results. So, the answer to your question is, I think we can tell only in part.

QUESTION: Governor, simple economic theory to which we have been exposed is that you cannot for long conduct international trade with large excesses of exports over imports, or vice versa. Yet, each speaker we have heard this week has exhorted us to export, export, export. And yet, to eat, countries like Great Britain export or die, how long can you do this without getting caught up somewhere along the line?

GOVERNOR BALDERSTON: Well, we have done it for 12 years now by lending them the money with which to buy our goods. As you indicate, there are other countries in addition to the United States that want to export more than they import. I was in Japan in November, and I was in Hong Kong on the same trip, and there it is certainly true that they must export to live. And in Britain, as you say, they have to export to eat, or at least to eat well. In contrast, some countries like India wish to import more than they export.

On the other hand, not all countries have the obligations of a world leader that we are trying to carry. If the industrialized nations, of which there are about six, would share those burdens, then the imbalance we are talking about might be diminished. Either we have to export more, or the burdens have to be lightened; one or the other, or both.

If Germany buys a half billion dollars worth of military hardware in this country, that is an assist. If she would do some of the lending to underdeveloped countries, that would be an assist. But obviously, they have to pay for what they buy from us. The way they pay is by shipping stuff into our country, which represents one of our imports. The imbalance has to be resolved somehow, if you are thinking about the long pull and the world as a whole.

COLONEL HARVEY: Gentlemen, we are going to have to blow a short whistle this morning. Governor Balderston is due in just 20 minutes to shoot for a record in the money management field, at a meeting of the Board of Governors.

Governor, on behlaf of your audience I would like to express our appreciation for a very fine insight into the operational policies of the Federal Reserve System. Thank you very much.

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