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The New Environment of Monetary Policy

I HAVE already attempted to demonstrate that the progress our nation has made in dealing with economic recessions has not yet been matched by similar progress in dealing with inflation. In grappling with the threat of depression, we have acted on a far larger scale than was ever contemplated during the 1920's. Not only do we command new tools for curbing recession, but we are willing to use them with promptness and vigor. More important still, our minds are prepared, should the need arise, for additions to the array of countercyclical weapons. In dealing with inflation, we have been less imaginative and less enterprising. It is true that the government is nowadays more concerned with the danger of inflation than it was in the immediate postwar period, and that foresight and courage have of late been mustered to check tendencies toward inflation as well as recession. Nevertheless, our intellectual, moral, and practical approach to the problem of inflation continues to suffer from earlier neglect. The heavy emphasis that the government has recently placed on a restrictive credit policy has served to bring us back to the best thought that ruled on the subject of inflation during the 1920's,

Millar Lecture at Fordham University, October 22, 1957. Reprinted, by permission of the publisher, from *Prosperity Without Inflation*, Fordham University Press, New York, 1957, pp. 43–65.

but it has done no more than that. In the meantime the economic world has changed profoundly.

I

The great expansion of governmental activities since the 1920's has reduced the economic area over which a restrictive credit policy can nowadays be effective. In 1929, federal expenditures on goods and services accounted for about 1¼ per cent of the dollar value of the nation's total output. Other forms of spending—interest payments, pensions, grants-in-aid to the states, and sundry subsidies—brought total federal expenditures to 2½ per cent of the nation's output. The outlays by state and local governments were a larger factor in the economy, but the combined expenditures of all our governmental units still accounted for less than 10 per cent of the nation's total output. Since then, governmental outlays have increased tremendously, in relation to the growth of the economy as well as in an absolute sense. During the past decade federal expenditures alone have ranged from 13.4 per cent of the dollar value of the nation's output in 1947 to 21.3 per cent in 1953 and 17.4 per cent in 1956. State and local outlays, which fell well behind federal expenditures during the 1940's, have also been catching up of late. The combined sum of federal, state, and local expenditures was over 104 billion dollars in 1956, or a little over 25 per cent of the nation's total output. In each of the four preceding years this percentage was still higher.

Federal expenditures are shaped by numerous and complex forces on the domestic and international fronts, but they are practically unaffected by the level of interest rates or the availability of credit. When federal revenues are high enough to finance larger outlays, as has been the case since fiscal year 1955, there is no need to resort to financial markets beyond

meeting temporary cash needs and refinancing the debt that keeps falling due. On the other hand, when deficit finance is being practiced, the condition of the money market is not likely to count significantly among the factors that lead the government to enlarge the deficit or to reduce it. If the federal government should again find itself spending more than it raises in taxes, it will not be because money may be borrowed on easy terms. Nor would the government be inclined to reduce its spending merely because borrowing has become harder. In the last analysis, the federal government has considerable power to shape the markets for money and capital to suit its ends; and it may well choose to do that rather than permit high objectives of national policy to be thwarted by any tightness of credit.

State and local governments have no such financial independence. However, the rapid growth of population, a continuing trend toward suburban living, and the shortages that accumulated during the Great Depression and World War II have created in many communities a sense of urgency with regard to schools, parks, highways, water systems, and other public improvements. Some projects have of late been shelved here and there because of statutory ceilings on interest rates or because of the reluctance of local citizens to assume the burden of a rising interest rate. Also, offerings of revenue bonds and other issues of local authorities have in some instances been withdrawn or postponed because of the congested condition of the capital market. By and large, however, state and local governments have either enjoyed sufficient revenues to finance their desired scale of expenditure, or they have been willing to submit to higher interest rates. The benefits to be derived from most governmental projects cannot be calculated in dollars, and this of itself tends to blunt the influence of interest rates. At least during recent years, state and

local expenditures have responded neither promptly nor on any large scale to general credit conditions.

But if government expenditures are largely sheltered from ordinary fluctuations in the credit market, so also are the operations of a part of the business world. Moreover, this part seems to have grown since the 1920's. Many business firms are able to finance their requirements—whether for new plant and equipment, or the accumulation of inventories, or the carrying of receivables—without any borrowing or without much borrowing. What these businesses do is to finance their requirements largely from internally generated funds—that is, undistributed profits, depreciation allowances, and related charges. From 1947 through 1956 corporations retained, on the average, 54 per cent of their profits. Between 1923 and 1929, on the other hand, retained corporate income averaged only 33 per cent. Depreciation funds and other allowances for capital consumption have likewise become of larger importance in corporate financing. In all, the internally generated funds of business corporations exceeded their externally raised funds—that is, new capital issues, bank loans, mortgages, trade debt, and other liabilities—by 42 per cent during the decade from 1947 through 1956. Between 1923 and 1929, on the other hand, corporate internal funds appear to have exceeded their external funds by about 10 or 20 per cent.

The requirements for external financing have, of course, increased greatly in an absolute sense. Not only that, but during the recent boom, corporations have found it necessary to turn increasingly to banks and the capital market to finance their vast expansion and improvement programs. Whereas internal funds exceeded external funds by 42 per cent over the full period from 1947 through 1956, this excess dropped to 26 per cent during the last two years of the period. Despite the recent revival of stock issues, borrowing has continued to be the pre-

ponderant source of external capital for corporations. However, in view of the steep rates of taxation that have ruled of late and in view of the rapidly growing use of amortizable loans, interest rates appear to have had less influence on corporate borrowing and investment than they had during the 1920's or earlier times of our history.

Interest charges are rarely a large element in business costs, and their practical importance has tended to become smaller as a result of high taxes. A rise in the rate of interest from 4 to 5 per cent will raise annual interest charges from $4,000 to $5,000 on a loan of $100,000. But with a basic federal tax rate of 52 per cent on corporate income, the net added cost to a sizable corporation that manages to stay in the black is $480, not $1,000. In fact, the net added cost is likely to be even smaller, since about two-thirds of the states nowadays levy a tax on corporate income which, while quite small relative to the federal tax, is not negligible either financially or psychologically. In the case of unincorporated businesses or households, the high rates of the personal income tax in the middle and upper income brackets likewise take some of the sting out of a rising interest rate. During the 1920's income taxes were, of course, much less formidable and therefore interfered less with the effects of interest rates. The federal tax rate on corporate incomes in those years was 13½ per cent at its highest, federal taxes on individual incomes were much lower than at present, and only a minority of states as yet imposed any income taxes. Hence, allowing for taxes, a rise of interest rates from, say, 4 to 5 per cent meant just about that during the 1920's, while nowadays it means roughly a rise of only half that size—that is, from 2 to 2½ per cent—for many borrowers, at least some of whom are sure to ignore so small an increase in cost.

Another factor that has served to blur the influence of a rising interest rate is the development and rapid growth during

the past ten or twenty years of versatile instruments calling for systematic amortization of loans. Term loans to business running up to five or ten years were practically unknown during the 1920's. Nowadays, they are a significant item in the portfolios of many insurance companies as well as of commercial banks. The long-term fully amortizable mortgage was largely developed during the 1930's, in connection with governmental efforts to stimulate homebuilding activity. This type of loan, which was of interest mainly to savings and loan associations during the 1920's, now dominates the mortgage market. Consumer installment loans were already of some consequence during the 1920's, but they have grown immensely since then in relation both to consumer incomes and to retail trade. The essential feature of these newer loan instruments is that they can be tailored to the needs of the borrower. The interest rate remains, of course, one of the terms of the loan contract. However, since other terms can also be varied, the importance of the interest rate is often reduced or obscured.

A rise in the interest rate is never welcome news to a borrower. But a businessman is apt to be less troubled by a rise in the interest rate if other dimensions of the loan contract are adjusted to his liking; for example, by lengthening the term to maturity and arranging a convenient repayment schedule. Certainly, the size of the initial down payment and the amount of the monthly installment are more vital to the typical buyer of an automobile on credit than the precise level of the interest rate that must be paid on the loan. The same is true of the buyer of a television set, an air conditioning unit, or a new home. Indeed, the deterrent effect of higher prices, to say nothing of higher interest rates, can often be offset by lengthening the period over which the loan can be repaid or by reducing the required down payment on the purchase. Recent experience has demonstrated that such liberalization of the

terms of loans can go on for a time on a very considerable scale in the face of a restrictive credit policy and rising market interest rates. During the greater part of 1955, credit terms were extensively liberalized on installment sales of automobiles and on veterans' mortgage loans. Although terms stiffened on mortgage loans in 1956, the average maturity of automobile loans continued to increase, particularly in the case of used cars. Even this year there has been little evidence of any significant tightening of terms.

Of course, direct rationing of available funds by lenders always goes hand in hand with the impersonal rationing through market interest rates. But if higher taxes and more flexible loan contracts have tended to reduce the restraining influence on the nation's business of a rising interest rate, other financial developments have served to lessen the control of the monetary authorities over the availability of loan capital.

The Federal Reserve System can exercise a decisive influence on the level of reserves and therefore on the total assets of its members, which are preponderantly commercial banks. The Federal Reserve System wields no authority, however, over other financial intermediaries such as life insurance companies, savings and loan associations, savings banks, investment companies, and pension funds. In the aggregate, institutions over which the Federal Reserve System has only an indirect and somewhat remote influence have been growing more rapidly than commercial banks. In 1955 the assets of commercial banks were about four and one-half times as large as in 1922. On the other hand, the combined assets of mutual savings banks, the postal savings system, credit unions, and savings and loan associations were about eight times as large. The combined assets of life insurance companies, other insurers, and private and public pension funds were sixteen times as large. The assets of government lending institutions and of investment

companies have increased still faster. As a result of these uneven trends, the assets of commercial banks, which at the end of 1922 somewhat exceeded the combined assets of other financial institutions exclusive of the Federal Reserve Banks, amounted to only 52 per cent of the total assets of these other financial institutions at the end of 1955.

The fortunes of commercial banks have not been subject to any simple trend such as the statistics just cited may suggest. The assets of commercial banks changed little in relation to the assets of other financial institutions during the first two decades of the century. The relative position of commercial banks then declined during the 1920's, but rose again between 1933 and 1945. It has declined sharply since then, and now appears to be lower than at any time at least since 1900. Although the assets of commercial banks increased 50 billion dollars between the end of 1945 and the end of 1955, the assets of other financial intermediaries, again excluding the Federal Reserve Banks increased about 230 billion dollars. This disparity of growth appears to be continuing. During 1956 the assets of commercial banks increased 7 billion dollars, while the assets of other financial intermediaries increased about 25 billion dollars.

Since the end of World War II the spectacular growth of the assets of financial institutions other than commercial banks reflects only in small part the rise in stock prices. What it basically signifies is the efficiency of financial markets in assembling "idle" funds and putting them to work in commerce and industry. This process not only can continue in the face of restrictions on the growth of commercial bank assets, but it is even likely for a time to be accelerated by a restrictive credit policy. A rise of interest rates increases the cost of holding demand deposits, on which commercial banks have been forbidden to pay interest since 1935. Hence, rising interest rates, es-

pecially if the movement is of considerable magnitude and duration, tend to stimulate both consumers and business firms to convert their cash balances into earning assets. This can often be done without any significant loss of liquidity. For example, when an individual draws on his checking account to buy a life insurance policy or to acquire savings and loan shares or to deposit funds in a mutual savings bank, he obtains against a financial institution a claim which can be readily converted into cash. The institution, in turn, having acquired ownership over a part of his demand deposit, now has additional money to lend to others who are likely to be active spenders. Much the same thing happens when a corporation buys the commercial paper issued by a sales finance company, especially when the transaction is handled through a repurchase agreement. In these and other ways the loans of financial intermediaries can for a time grow quite rapidly even when the reserves of commercial banks are severely restricted by Federal Reserve actions. This is precisely what has happened since 1954.

The rapid growth of financial institutions other than commercial banks is not, however, the only development of recent times that has tended to limit the control that the Federal Reserve System can exercise over credit expansion. The emergence of a large amount of federal government securities in the portfolios of commercial banks has had a similar influence. During the 1920's Treasury securities were a minor factor in the operations of commercial banks. For example, they accounted for 10 per cent of the assets of the member banks of the Federal Reserve System in mid-1922 and for only 8 per cent of their assets at the end of 1929. During the 1930's and during the war years, however, a large part of the rapidly growing federal debt found a home in commercial banks. At the beginning of 1946 the member banks held 57 per cent of

their assets of over 138 billion dollars in the form of Treasury securities. Bank holdings of government debt have considerably diminished since then, both in amount and in relation to their total assets. Nevertheless, Treasury securities still amounted to 58 billion dollars, or about a third of the total assets of the member banks, at the end of 1954 when the recent boom was getting actively under way.

These large holdings of government securities add immeasurably to the flexibility of bank management. In particular, they enable commercial banks to replenish their supply of loan funds, if they so wish, and thereby to circumvent for a time the restrictions that the Federal Reserve authorities may impose on their reserves. A bank does not like to disappoint any of its regular customers. Nor, for that matter, does it care to turn down a new applicant of substance and reputation. After all, if his needs are met in whole or in part, he may well bring his future business to the bank which was willing to go to some trouble at a time of credit stringency to accommodate him. To the extent that a bank holds short-term Treasury securities, it can acquire funds for loan expansion without sustaining an appreciable capital loss. The disposal of long-dated securities is a more costly method of raising loan funds at a time of rising interest rates. However, a higher interest rate on a new loan will often compensate a bank for the loss it sustains by selling bonds. Even when that does not happen, the need to look after a customer may of itself induce a bank to reduce its holdings of long-term Treasury issues.

In fact, commercial banks have responded to the surging demand for credit in the recent expansion by disposing of both short-term and long-term securities on a very considerable scale. The loans and investments of all commercial banks increased only 9.2 billion dollars between the end of 1954 and the end of 1956, or by 6 per cent over the two-year period.

Their outstanding loans, however, increased by 19.7 billion dollars or 28 per cent. This huge expansion of loans by commercial banks was accompanied and made possible in large part by a reduction of 10.4 billion dollars in their holdings of federal obligations.

The great volume of outstanding federal securities has increased the financial maneuverability of all types of financial institutions, not only of commercial banks. Thus, the assets of mutual savings banks and insurance companies increased very substantially during 1955 and 1956. The inflows of cash on account of new savings and debt repayment were not sufficient, however, to enable the managers of these institutions to make all the loans or acquire all the private or state and local securities that they deemed advantageous. Hence they disposed, in the aggregate, of 3 billion dollars of their holdings of federal obligations. The Treasury securities sold by them and by commercial banks were largely bought, on balance, by individuals, by the federal trust funds, and by various state and local investment accounts. In 1955, when the recent spurt in plant and equipment expenditures was still in its early stages, business corporations added a little over 4 billion dollars of Treasury securities to their holdings. In the following year, when outlays on investment were much larger and the stringency of the money and capital markets was greater, they disposed of almost 5 billion dollars of their securities. Thus, the huge sales of government securities by financial institutions during 1955, and both by them and business corporations during 1956, served—along with other devices to which I have alluded—to mobilize the nation's cash and put it to work in the nation's markets. This process went on in spite of and partly in response to the efforts of the Federal Reserve System to restrain the expansion of credit and, through that, the expansion of spending across the nation.

II

I have suggested that various financial developments—the growth of government expenditures, our steep tax rates, the lesser dependence of corporations on external financing, the greater flexibility of loan instruments, the relative decline of commercial banks among financial intermediaries, and the large holdings of Treasury securities by financial institutions—have all tended to reduce the effectiveness of traditional monetary restraints. Of course, these are not the only financial developments of recent times that bear on monetary policy. Nor have all the changes in our financial environment worked in the same direction. Surely, the breakdown of the international gold standard has made it possible to base our monetary policies to a greater extent on domestic considerations than was feasible during the 1920's. Other recent developments, such as the emergence of a large volume of real estate mortgages underwritten by the government, have made it easier to shift funds from one part of the country to another or from one financial institution to another. The large holdings of government securities by financial institutions, business corporations, and the general public have had a similar effect. But if these factors have facilitated the transmission of Federal Reserve pressures on commercial banks to other parts of the economic community, they have also facilitated ways of escape, at least temporarily, from these pressures. On balance, there appears to be little doubt that the net effect of the vast changes that have occurred in recent times in the realm of finance has been to blunt to some degree the effectiveness of Federal Reserve policies aiming at the restraint of the nation's spending.

This does not mean that the Federal Reserve authorities have inherently less power than they had during the 1920's. In

a theoretical sense their power to restrain expansion is fully as large or even larger. For not only are they able to exert pressure on commercial banks by selling government securities, of which they hold a great abundance, but they can raise the reserve requirements of the member banks—a power they did not have in the 1920's. Viewed in the abstract, there is almost no limit to what the Federal Reserve System can accomplish, despite the narrowing of the base to which its policies apply. Just as the Federal Reserve System is capable of offsetting a shift from demand deposits to time deposits in commercial banks, so it could offset a shift of demand deposits from individuals to financial institutions. If the Federal Reserve authorities sought to prevent the assets of all financial institutions, taken in the aggregate, from increasing, they could in principle force a sufficient reduction of commercial bank assets to compensate for the growth in the assets of other financial institutions. All this, and indeed much more, may be said of the powers of the Federal Reserve System. The essential point of the preceding analysis, however, is that in order to achieve a particular effect on the nation's total expenditure in today's environment, the degree of credit restriction which needs to be taken is likely to be appreciably greater than was the case a generation ago. But if our economic and financial environment has changed, the political environment has changed still more and the changes have not been of a kind that favor highly restrictive credit policies.

The Employment Act of 1946 pledges the federal government to "utilize all its plans, functions, and resources" to foster economic expansion and to help prevent depressions. The Federal Reserve authorities, being members of the government, are bound by this statutory declaration of policy. In principle, a restrictive credit policy at a time of surging demand is entirely in harmony with the objectives of the Employment Act. Al-

though not all depressions spring from excessive exuberance during periods of prosperity, that has been the course of events in the past altogether too often. Once extensive speculation gets under way—whether in commodities or securities or real estate—the foundations on which the nation's prosperity rests become insecure. So it is also when the quality of newly extended credit seriously deteriorates, or when a competitive rush develops to construct physical facilities that, in the aggregate, are well beyond current requirements. Of late, these teachings of experience have counted heavily in the economic thinking of government officials outside as well as within the Federal Reserve System. But if concern over the continuance of prosperity has at times led to credit restrictions, it has also led to a gradual application of these restrictions. Now that our government is committed to doing what it can to promote maximum production and employment, the Federal Reserve authorities are fairly bound to pursue a policy of credit restraint with considerable caution, lest the application of restraints bring on the very decline of aggregate economic activity which it is the responsibility of government to try to prevent.

The virtual avoidance of general credit restraints over the long stretch from 1933 to 1951 has also left its mark on current thought and practice. The earlier policy was based on the belief, which came to be held rather widely in professional and political circles, that on the one hand, general credit controls could check a boom with dangerous ease and, on the other hand, that they could do little to speed recovery once a depression developed. This exaggeration of the restrictive power of credit controls was, on a superficial view, strikingly confirmed by the course of events in early 1953. The pressure on bank reserves then exercised by the Federal Reserve authorities, to-

gether with a substantial issue of 3¼ per cent bonds by the Treasury, was interpreted by many in the financial community as a signal that interest rates would soon rise further and that it would become more difficult to obtain credit. Something of a scramble for money developed, interest rates rose briskly for a few weeks, and some dealers were undoubtedly embarrassed. These happenings in financial markets were not, however, a typical response to a moderate degree of credit tightening. More than anything else, they reflected the bewilderment of a financial community that had become accustomed to stable interest rates and had forgotten how a restrictive credit policy works. Government officials could overlook the criticism that "tight money" brought on the industrial recession which became visible around mid-1953. They knew better, as did many others. However, they could not escape the fact that they had misjudged the psychology of financial markets. The memory of this minor embarrassment understandably made them more cautious in the next encounter with economic excesses.

Moreover, government officials—the Federal Reserve authorities among them—must reckon with the opposition that restrictive credit measures often arouse in business, labor, and political circles. The influence of Federal Reserve actions on the wage policies of trade unions and the pricing policies of business firms is, at most, indirect. Surely, as we have recently seen, a new round of wage and price increases can occur in the face of a restrictive credit policy. But once a higher consumer price level has been established, it becomes unrealistic to look to the Federal Reserve System for a restoration of the former price level. All that may reasonably be expected of the Federal Reserve System is that it will do everything it can, within its limited powers, to keep the price level from rising further. A credit policy that is sufficiently restrictive to bring down the

price level is, to be sure, always possible. But a policy which did that would in all likelihood bring down also the volume of employment. Federal Reserve officials are likely to shrink from such a course, not only because of their responsibility under the Employment Act, but also because they are apt to feel, whether consciously or not, a wholesome concern over the political uproar that would follow.

Another practical factor that has tended to limit the application of credit restraints is the recurring need of the Treasury to borrow money. Of late, this has usually involved the refunding of outstanding debt rather than the issue of new debt. But in view of their magnitude and frequency, the refinancing operations of the Treasury are still a very formidable obstacle to the consistent pursuit of a restrictive credit policy. For example, apart from the weekly rollover of bills and three special issues of bills, the Treasury entered the money and capital markets four times in 1956: in March to refinance 9.5 billion dollars of its securities, in July to refinance 12.9 billion, in August with a new issue of 3.2 billion, and in December with a refinancing of 9.1 billion. In 1955 the Treasury made even more trips to the financial markets and raised still larger sums, and so it has also been this year. Treasury debt operations, of course, are not a new thing for the Federal Reserve System. During the 1920's, however, the federal debt was a smaller factor in financial markets. Not only that, but the debt was then being reduced steadily and a smaller proportion of the outstanding debt was of a short-term character.

The current financing problems of the Treasury stem largely from the short maturities of a great part of the outstanding public debt. This creates not only administrative difficulties for the Federal Reserve System; it also tends, however subtly, to impart a bias to monetary policy. During a time of economic boom, a Secretary of the Treasury may well feel that, unless

credit expansion is restricted, commodity prices are likely to rise swiftly, upset his budgetary calculations, and eventually cause economic trouble all around. He may therefore favor a restrictive policy and even assume a certain leadership in its behalf. At the same time he cannot entirely overlook the fact that when a forthcoming Treasury issue carries a higher interest rate than the one falling due, it must raise at once, however modestly, the government's expenditures. Nor can he ignore the possibility that, in the absence of support by the Federal Reserve System, a newly projected Treasury issue may, besides being poorly received in financial markets, seriously upset the prices and yields of outstanding securities, both public and private. If he communicates such thoughts to the Chairman of the Federal Reserve Board, he is merely acting in the line of duty. And in fact, all this is so clearly understood and recognized that the Federal Reserve authorities can be counted on to take the Treasury's needs into account without being prodded. The practical result is that restrictive credit actions, which are otherwise deemed desirable, are not infrequently postponed or that easing actions, which are otherwise deemed undesirable, are temporarily undertaken. Once the Treasury issue is out of the way and more or less absorbed, the Federal Reserve authorities are again free to act. But neither the economy nor human sentiment ever stands perfectly still. Once a restrictive action has been delayed, some subtle change in the one or the other may cause further delays. In the end, not only is the timing of Federal Reserve actions apt to be somewhat distorted from the viewpoint of the interests of the general economy, but the entire range of actions taken in the course of a boom is likely to be somewhat less restrictive than it would have been if the Treasury's trips to the financial markets for substantial sums had come less frequently.

III

I have already commented on one of the two major risks that unavoidably accompany a policy of general credit restraint—namely, that if the policy is pushed too far, it may hasten or bring on a business recession. The second risk is that if such a policy is continued over a considerable period, it may have undesirable side effects on the character or structure of the nation's economic activity. With increasing frequency, the charge has of late been made that a restrictive credit policy has uneven effects on the economy, that general credit restraints are selective in their practical effects, and that small businesses, homebuilders, prospective homebuyers, and local governments, especially school districts, bear the main brunt of general credit controls. The intensity with which these criticisms have been urged is of itself a fact with which government officials, including the Federal Reserve authorities, have had to reckon. Beyond that, and in the degree to which the criticisms are valid, they raise the question whether the side effects of general credit restraints may not offset some of the economic benefits that could be gained by their more vigorous application at a time of economic exuberance.

The financing difficulties of state and local governments appear to have been exaggerated in recent discussions. It is true that some municipal issues ran into trouble as early as 1955, while postponements of corporate issues did not come into public view until 1956. But there is little evidence that school bonds have suffered to any great extent in recent markets. In the nine critical months from July 1956 to March 1957 school bond issues were marketed at the highest rate yet recorded. Unsold bonds were only 3 per cent of the dollar amount of school bond offerings during this period. Taken in the aggre-

gate, the capital issues of state and local governments, just as the capital issues of business corporations, have been exceptionally heavy this year.

The experience of small businesses during the recent period of general credit restraint appears to be a more serious matter. It is necessary to distinguish, of course, between the financing difficulties of small businesses that are of a chronic nature and those that are peculiar to a time of credit stringency. The ability of a small enterprise to expand is undoubtedly affected by our high tax rates, which severely limit the profits that can be ploughed back into business. Also, a small firm typically has little or no access to the public markets for capital. All this applies to times when credit conditions are easy just as it applies to a time of credit stringency. It is claimed, however, that when the reserves of commercial banks are under pressure, the financing problems of small firms are apt to become aggravated. Most banks, to be sure, will do everything they can to look after the needs of their regular customers, small or large. But if it is hard to turn down or to meet only in part a request for a loan by any sound business firm, it may be especially hard when the firm is large and powerful. In any event, a large firm of good reputation which cannot obtain credit from one bank can ordinarily shop around and eventually obtain a loan from another institution or, perhaps, float a public issue. Opportunities of this type are far more limited for the typical small business.

These judgments are based on general impressions. Facts on this important subject are unavailable on a precise and comprehensive basis. There are, however, various scattered pieces of evidence. First of all, we have the experience of the Small Business Administration, which received almost twice as many applications for loans in 1956 as in 1955. Not only that, but the percentage of approved applications rose from 38 in 1955 to 49

in 1956 without, apparently, any change in credit standards. Second, there is a special study by the American Bankers Association, based on a sample of large banks, which shows that the dollar amount of outstanding loans of under $50,000 increased a little over 14 per cent between the end of August 1955 and a year later. This is a considerable increase. Yet the commercial, industrial, and agricultural loans of weekly reporting member banks, which cover a larger sample of the big banks, show an increase of 21 per cent. Taking the two sets of figures together, it would appear, therefore, that the dollar amount of business loans in excess of $50,000 increased by something more than 21 per cent. Third, we have the quarterly compilations of new short-term loans, classified by size of loan, and covering a sample of large banks in nineteen cities which report to the Federal Reserve Board. According to this sample, the dollar amount of new loans ranging from $1,000 to $10,000 declined 4 per cent between 1955 and 1956, while there was an increase of 3 per cent in the loans from $10,000 to $100,000, of 9 per cent in loans from $100,000 to $200,000, and of 42 per cent in loans of still larger size. Fourth, we have the quarterly financial statements for manufacturing corporations compiled by the Federal Trade Commission and the Securities and Exchange Commission. From these figures it appears that the largest corporations, those with assets of over 100 million dollars, increased their indebtedness to banks by a substantially larger percentage between 1955 and 1957 than did small- or medium-sized corporations. The evidence is less clear, however, when long-term debt, beyond that already included in bank loans, is also considered.

These statistics leave much to be desired. The first piece of evidence, drawn from the experience of the Small Business Administration, tells nothing of the difficulties that some large firms experienced in obtaining credit. The second piece of

evidence, which relates to the change in the total of outstanding bank loans of under and over $50,000, rests on different samples. The third piece of evidence, which refers to new bank loans of varying size, is restricted to a sample of large banks and therefore is apt to understate the over-all increase of small loans relative to large loans. A similar bias is likely to flow, at a time of generally rapid loan expansion, from fixed-size classes for loans. The fourth piece of evidence, which refers to outstanding bank loans of manufacturing corporations of differing size, is subject to uncertain defects of coverage. Furthermore, it makes no allowance for the changing composition of industry which is always an important feature of a cyclical expansion in business. A similar limitation attaches also to the second and third pieces of evidence. There are still other difficulties that attach to the statistics cited. Nevertheless, it is difficult to escape the broad but definite impression that, although the financing problems of small business have been greatly exaggerated and although interest rate differentials have in fact moved in favor of smaller businesses, the recent credit restraints have had a greater impact on the availability of credit to small businesses than they have had on the large firms.

It also seems clear that credit restraints have had a part in the recent decline of the homebuilding industry. In December 1954, housing starts, taken on a seasonally adjusted basis, reached a level exceeding 1.4 million units. They have declined since then to a level of about 1 million. Overbuilding in some localities, higher construction and land costs nearly everywhere, and a more selective, if not also a lessened, demand have contributed to the decline, but credit conditions appear to have been the most important single factor. Interest rates are a fairly large element in the cost of home ownership, particularly for families in low income brackets. To some degree,

therefore, rising interest rates would of themselves tend to restrict the volume of homebuilding. Legal impediments to the free movement of interest rates on federally underwritten mortgages, however, have made matters much worse.

With the rise of interest rates during the recent boom, the maximum interest rates fixed by law or regulation for federally underwritten mortgages soon became unrealistic and these mortgages could ordinarily be placed or sold only at a discount. The practice of discounting, however, is poorly understood and sometimes arouses intemperate criticism. To avoid possible embarrassment on this account, some financial institutions concentrated increasingly on conventional mortgages. The supply of money for underwritten mortgages, on which the homebuilding industry has come to depend very heavily, was therefore reduced. At the same time, as a result of the provision of law which practically requires the builder to absorb any discount on mortgages guaranteed by the Veterans Administration, the builder's profit tended to dwindle as the discounts became larger. Hence the inducement to build was diminished. In short, in view of our housing legislation with its special regulation of interest rates and discounts, the recent policy of general credit restraint acted as a selective credit control on homebuilding. It would, of course, be equally correct to say that, in view of the recent policy of general credit restraint, our housing legislation acted as a selective credit control. Changes in the law governing discounts which were passed by the Congress this year have accentuated this difficulty, and they are likely to do so again under conditions of tight credit.

IV

I am led by this lengthy discussion of financial trends to three broad conclusions. First, since various economic and political

developments of recent times appear to have reduced the effectiveness of Federal Reserve restraints on over-all credit expansion, we must discipline our expectations of what can be accomplished through general credit controls. There is little doubt that, given enough time, the Federal Reserve System is still capable of checking any large-scale expansion of aggregate demand. The process of economizing on cash cannot be stretched indefinitely by households or by the business community. As the holdings of Treasury securities by financial institutions are reduced and as the cash balances of individuals and corporations become smaller in relation to their transactions and contingent needs, the avenues of escape from the pressure applied by the Federal Reserve authorities on the reserves of commercial banks are bound to become fewer and narrower. This process, however, takes considerable time. Since 1954, we have experienced a credit shortage in the sense that interest rates have risen sharply and also in the sense that many have borrowed less than they would have liked or wanted to borrow. We certainly have not had a credit shortage in the sense that the amount of credit expansion has been small. In the meantime, as everyone knows, the price level has risen disconcertingly.

Second, although the side effects of a restrictive credit policy are of little consequence if the policy is applied over a few months, they cannot be safely ignored if the policy is extended over years. The traditional assumption that general credit controls exercise something like a uniform impact on different sectors of the economy appears to be invalid. When the government embarks on a restrictive credit policy, it does this with a view to restraining the growth of total expenditure, not to benefit one type of activity or to injure another. In practice, however, some branches of activity, such as those in which the federal government itself is engaged, are untouched by general

credit restrictions. In other activities, such as consumer installment buying, the effects are seriously felt only after a very substantial lag. On the other hand, small businesses and the home-building industry are apt to feel the impact of general credit restraints fairly promptly and more keenly. But not only do general credit restrictions have selective effects, it also appears that these effects may interfere with some key objectives of national economic policy—such as the extension of home ownership, the promotion of sound neighborhoods, and the maintenance of an environment in which small and new businesses, which are a vital source of innovation in our economy, have a reasonable opportunity to survive, prosper, and grow. The government has therefore recently sought to reduce the uneven impact of credit restrictions by enlarging the loan funds available to the Small Business Administration, and by adopting a variety of measures in behalf of housing.

Third, in view of the limitations that attach to restrictive Federal Reserve policies, it would be unwise to depend on the Federal Reserve System as our sole or principal guardian of the stability of the dollar. If the struggle against creeping inflation is to be successful, we must proceed simultaneously on numerous fronts. General credit controls have an important place in any responsible program for protecting the stability of the dollar. However, they need to be accompanied by other measures of policy that, in the first place, will reduce the burden that needs to be carried by our monetary authorities and, in the second place, improve the chances of success in their special sphere of activity.