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FEDERAL RESERVE POLICY AND ECONOMIC STABILITY 1951–57

REPORT

STUDY PREPARED BY

ASHER ACHINSTEIN

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COMMITTEE ON BANKING AND CURRENCY

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STATEMENT OF THE CHAIRMAN

The Federal Reserve Board is an agency directly responsible to the Congress. Its action or lack of action with respect to the flow of credit may affect the stability and growth of the economy. Congress must therefore be concerned with how the Board uses its monetary tools and the adequacy of these tools for stabilization purposes.

The Treasury-Federal Reserve accord of 1951 restored the independence of the Federal Reserve from the Treasury, an independence which the record shows could not have been achieved without energetic support in Congress. Since that time monetary policy has increasingly been in the forefront of discussion in newspapers and periodicals, in academic circles, and in Congress. The views expressed have ranged from general endorsement of Federal Reserve policies to fundamental skepticism which regards monetary tools as weak reeds on which to lean in the promotion of economic stabilization.

In view of such basic differences and the likelihood that Congress will be considering a number of measures relating to monetary policy and economic stabilization, I considered it important to review Federal Reserve policies since the accord. Recent events have shown that the economy is still subject to sizable fluctuations in aggregate economic activity, and inflationary as well as deflationary developments are ever present phenomena. I felt it desirable to have an independent analysis of Federal Reserve policies from 1951 through 1957 which would throw light on the adequacy and the use of the tools employed by the Federal Reserve Board.

Any review of Federal Reserve policies is, of course, bound to be controversial. Were it to be prepared by the Board itself, one would expect it to consist mainly of explanation and justification of past actions. I preferred to have the study prepared by an economist uncommitted to an official or a doctrinaire viewpoint but who, nevertheless, possessed professional qualifications of a high order. For this reason, I requested that the services of Dr. Asher Achinstein, senior specialist in the Legislative Reference Service of the Library of Congress, be made available to prepare this report. He was assisted by Mrs. Elizabeth M. Boswell.

Dr. Achinstein is an acknowledged expert in business cycles and has demonstrated his scholarship, objectivity, and independence in dealing with the problems of economic policy. He is the author of Introduction to Business Cycles, a standard textbook on economic fluctuations. He was associated in 1953 and 1954 with Dr. Arthur F. Burns, Chairman of the Council of Economic Advisers, in the preparation of the first two Economic Reports of President Eisenhower, and has served as economic consultant to the Senate Banking and Currency Committee.

While the committee and the individual members take no position on the report, it nevertheless deserves the careful attention not only

of the Congress but of all citizens concerned with the vital issues of monetary policy. Not the least of its contributions is that it focuses attention on problems requiring further research and study.

Dr. Achinstein's study was submitted to the staff of the Federal Reserve Board for comments and many of these were incorporated. In view of the fact that all of their suggestions were not accepted, the Board's staff was invited to prepare a statement to be published along with the report.

J. W. FULBRIGHT.

SUMMARY

This report examines Federal Reserve policies in terms of the fluctuations in aggregate economic activity from 1951 through 1957. The following statements from the Douglas Subcommittee Report of 1950 on Monetary, Credit, and Fiscal Policies, quoted at the very outset of the study, indicate two of the underlying basic premises for this review.

> (1) We recommend that an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of the principal methods used to achieve the purposes of the Employment Act.
>
> (2) The essential characteristic of a monetary policy that will promote general economic stability is its timely flexibility. To combat deflation and promote recovery, the monetary authorities must liberally provide the banking system with enhanced lending power, thereby tending to lower interest rates and increase the availability of credit. To retard and stop inflation they must restrict the lending power of banks, thereby tending to raise interest rates and to limit the availability of credit for private and Government spending. And these actions must be taken promptly if they are to be most effective.

A corollary to these basic propositions is that appropriateness and timeliness of monetary actions must be judged in the light of the economic developments unfolding during the period. Not all economic changes warrant monetary actions of a contracyclical character. Nor is the test of successful application of the principle of timely flexibility the complete elimination of fluctuations in general business activity. What may be expected from the monetary authorities is a reasonably good diagnosis of the current changes taking place in the economy and such use of their tools as to minimize economic instability. To be sure, they are not omniscient and are bound to make mistakes in appraisals of current developments and in the use of their instrumentalities. One of the virtues of monetary policy, as compared to fiscal and debt-management policy, is that the monetary authorities are usually in a better position to minimize errors of diagnosis or of action by more speedily steering a different course to meet changing conditions. Whether monetary management actually exhibits the desirable degree of flexibility is another matter.

When the Treasury-Federal Reserve accord was reached on March 4, 1951, it was hailed as an important development marking the end of a decade during which monetary policy had been subordinated to debt-management policy. The outbreak of the Korean war in June 1950 had touched off strong inflationary pressures and it had become increasingly evident that credit expansion would continue to feed the upward price spiral, so long as the Federal Reserve System purchased large quantities of Government securities at pegged prices. It was in the light of these developments that the Treasury finally agreed to an

arrangement giving monetary policy a coordinate role with debt-management policy.

The significance of the accord lies in the fact that it paved the way for the Federal Reserve to exercise greater freedom in the use of its major instruments of credit policy for promoting economic stability. So long as the rigid support of the Government security market continued, open-market operations, the discount rate, and reserve requirements—the three principal methods for regulating the volume of bank credit and the money supply—could not be employed effectively.

The accord took place at a time when inflationary developments had about reached their greatest intensity. Wholesale commodity prices, which had risen by 16 percent during the first 9 months after the Korean war, reached their peak in March 1951, and began to edge downward more or less continuously until the end of 1952. The extent to which the accord was of strategic importance in weakening inflationary pressures after March 1951 is a debatable question. Federal Reserve officials are inclined to attribute an especially powerful role to the accord in curbing inflationary pressures; others emphasize instead the importance of the change in business conditions, particularly the cessation of the abnormally heavy forward buying by consumers and business firms when the anticipated war shortages did not develop. There were also additional anti-inflation influences in 1951—perhaps of lesser importance—such as direct controls over prices and wages by the Federal Government, and selective controls over real-estate credit, consumer credit, and credit for the security markets.

It was not until at least a year after the accord that the discount mechanism began to be reactivated as a major supplement to open-market operations as a tool for monetary control. This change coincided more or less with the acceleration in the pace of business activity and the intensification of the demand for bank credit toward mid-1952. As a result of the increasing pressure on bank reserves, bank borrowing at Federal Reserve banks rose from about $300 million in March 1952 to a record level of $1.6 billion by the end of the year.

The revival of the use of the discount window by member banks gave promise that the monetary authorities would henceforth be in a stronger position than they had been for about two decades to exercise restraint on credit expansion. It was thought that they could count on the traditional reluctance of the banks to borrow from the Federal Reserve, on administrative regulations discouraging continuous borrowing to replenish reserves, and on making borrowing more expensive through raising the Federal Reserve discount rate. It was also about the time of the accord that the view began to be influential among Federal Reserve officials that a policy of monetary restraint which results in even small changes in interest rates would curb bank-credit expansion. With a substantial part of the portfolios of banking and financial institutions consisting of Government securities, these institutions were thought to be sensitive to small rises in interest rates and to the capital losses involved in disposing of Government securities in order to switch into private loans.

The first half of 1953 is an especially instructive period, since it brings to focus some of the major problems that continue to confront

monetary management in its attempt to promote economic stability. The first relates to appraisal of the current business situation; the second to the influence of Treasury debt-management policy on monetary actions; and the third to the actual use made of the available instruments of credit control. It was also in this period that the Open Market Committee arrived at significant decisions with respect to its most important tool of monetary policy, namely, open-market operations.

During almost the whole of the first 6 months of 1953 the monetary authorities based their credit policy on the assumption of continuation of business expansion and the intensification of inflationary pressures. There were others who pointed out early in the spring of 1953 that the Federal Reserve Board's preoccupation with inflation resulted in its minimizing unfavorable developments indicative of an impending downward readjustment in business activity. With more or less the same statistical and other pertinent data available to competent and trained observers, such differences in appraisal of the current economic situation must be largely interpretative and analytical in character. However, psychological and other influences enter into these judgments. During this as well as in other periods of buoyancy in the economy at more or less peak levels, there is a general tendency for optimistic appraisals and the ignoring of imbalances that are building up and which are likely to result in deflationary developments.

Another influence that appeared to have resulted in overemphasis on the continuation of inflationary pressures was the decision of the Treasury early in the spring of 1953 to launch a program of refunding the debt into longer maturities. At the same time, the Federal Reserve Board was expounding a philosophy of the "free securities market" with open-market operations confined to the short-term securities and no intervention in the long-term sectors. These views of the Treasury and Federal Reserve brought forth criticism by economists and others that a free-market philosophy represented a degree of passivity on the part of the Federal Reserve which was likely to weaken credit policy as a tool for stabilization. Within the Federal Reserve System, Mr. Sproul, president of the Federal Reserve Bank of New York, opposed the "bills only" doctrine of the Open Market Committee, contending that it placed monetary management in a straitjacket.

By mid-1953 the Federal Reserve was moving vigorously to reverse the course of monetary policy from one of credit restraint to credit ease. This shift was initially made in response to a critical situation that had been permitted to develop in the financial markets rather than, as is sometimes asserted, to the expectation that the economy was about to slip into a business recession. Nevertheless, extensive midyear open-market purchases and lowering of reserve requirements created a favorable financial environment for meeting the problems of economic readjustment in the period immediately ahead.

The earlier restrictive monetary policy may have had some influence in the slackening of activity, but this in no way compares with the major importance in the 1953–54 business recession of the downward readjustment of business inventories and the cutback in defense contracts. The liquidation of inventories occurred because production and sales had fallen out of balance, especially in the consumer durable

goods sector, and because of curtailment of the defense program. These developments were independent of the tight-money policy.

Federal Reserve policy contributed substantially to moderating the recession and supporting economic recovery. All three major instrumentalities were employed after mid-1953. There was a further increase in open-market purchases in the last half of the year, the discount rate was lowered from 2 to 1¾ percent in February 1954 and to 1½ percent in April, and reserve requirements were reduced once more around mid-1954.

The policy of active ease made credit more available and lowered its cost considerably. With ample reserves and greater liquidity banks sought out new business more aggressively and greatly expanded their investment portfolios. The chief beneficiaries of the easy-money policy were the construction industry—especially housing, commercial and public works construction—and the stock market, with credit for trading in 1954 showing the greatest increase during any of the postwar years. Monetary policy would not have been so influential in recovery if the level of consumer spending had not remained so high, if the "automatic stabilizers" had not come into play, and if additional antirecession measures had not been undertaken promptly by the Federal Government.

For understanding the 1955–57 business expansion and the role played by the monetary factor, it is necessary to concentrate on 1955, when the expansion assumed its most rapid rate of increase and the volume of credit rose at a record rate. No single year so illuminates the shortcomings of monetary policy when the principle of appropriate and timely flexibility is violated. It also focuses attention on some of the limitations inherent in the existing tools of monetary control.

Between the third quarter of 1954 and the first quarter of 1955 the gross national product advanced at an annual rate of over $22 billion; about two-thirds of the increase was due to the sharp expansion in outlays for consumer durable goods, continued advances in purchases of new homes, and a shift from liquidation to accumulation in business inventories. The speedy economic recovery, which received its main impetus from these sectors, was accompanied by a substantial rise in credit and by a considerable easing in financial terms, especially longer maturities and lower downpayments on mortgage and installment credit. In the second quarter of the year, installment credit outstanding expanded by nearly $2 billion, a record rate in so short a period. The mortgage debt on 1- to 4-family homes increased by $6.5 billion during the first 6 months of the year. The upsurge in consumer expenditures for durable goods and housing was a major stimulus to the acceleration of business investment in plant and equipment during the latter half of 1955. In all of these developments the commercial banks played a powerful role through a $12 billion expansion of loans in 1955.

The first restrictive credit move by the Federal Reserve Board was the raising of margin requirements from 50 to 60 percent in January 1955. Since stock prices and stock-market credit had each risen by about 50 percent since September 1953, and speculative activity was increasing during the latter half of 1954, the 10-point rise in margin requirements could hardly succeed in checking the flow of credit to the market. In April, a month after the widely followed stock market hearings of the Senate Banking and Currency Committee were completed, margin requirements were raised from 60 to 70 percent. It

was only after this action was taken that the rate of increase in stock-market credit began to slacken considerably.

The record of the meeting of the Open Market Committee at the beginning of March 1955 shows that it was concerned that relaxation of terms for the rapidly expanding volume of consumer and mortgage credit represented a potential threat to stability. At the beginning of May, and even more so by the end of June, it noted that overall economic activity was reaching boom proportions with the likelihood of prices moving upward and that business, financial, and consumer confidence was extraordinarily high. It was therefore surprising, even in financial circles, that the Reserve banks waited until mid-April and early May to raise the discount rate from 1½ to 1¾ percent. The Federal Reserve waited another 4 months before it made a similar feeble attempt at monetary restraint when it raised the discount rate to 2 percent in August.

While open-market operations were conducted during the months of March through June so as not to increase bank reserves, it would seem to have been more appropriate, in view of the swelling demands for credit, if there had been direct intervention by the System to reduce bank reserves.

Federal Reserve officials have recently admitted that they should have moved faster and more vigorously in 1955. One reason for the failure to do so given by the presidents of the Reserve banks was that the economic data available in the first half of 1955 understated the speed of the recovery. This explanation for the inadequacy of monetary policy leaves much to be desired. If the monetary authorities failed to act more vigorously, it was much more a matter of judgment and interpretation than limitations inherent in the data. The Chairman of the Federal Reserve Board, in accounting for the tardiness and lack of vigor of the restrictive actions taken in the upswing, has acknowledged an important element ignored by the bank presidents, namely, the human factor of hesitancy to exercise curbs that might check the pace of business expansion.

Additional explanations for the inadequacy of monetary policy in 1955 may be found in the theory of credit control that seemed to be influential among officials of the Federal Reserve System as well as in the limitations of general monetary controls.

From the degree of pressure exerted in 1955 it would appear that the monetary authorities were still under the influence of the view propounded around the time of the accord that small increases in interest rates inhibit bank disposal of Government securities, thereby curbing bank-credit expansion. This theory received little support from actual financial developments in 1955 and the first half of 1956. Throughout this period interest rates were moving upward; the discount rate was raised 6 times from April 1955 to August 1956—from 1½ to 3 percent. In order to meet demands of their customers the banks disposed of more than $12 billion of Government securities in 1955 and up to mid-1956. It was not until the latter period that considerations of bank liquidity caused the shifting out of Government securities to cease. The Federal Reserve appeared to underestimate considerably the lag between the adoption of its policy of monetary restraint and the time when it could take effect.

The ineffectiveness of monetary policy was particularly evident in the case of consumer durable goods purchases. The rise in interest rates neither inhibited users nor lenders of installment credit. The

Federal Reserve had no authority to exercise selective controls over downpayments and maturities with which to check excessive expansion of consumer credit. It had such powers under temporary authority during 1941–47, 1948–49, and in 1950–52. Nor did it request the Congress for authority to regulate consumer credit at any time since the expiration of regulation W in mid-1952.

Despite the evidence that the rapid expansion of consumer credit in 1955, with its accompanying secondary impacts on capital investment, contributed to subsequent inflationary developments, the Federal Reserve Board arrived at the conclusion, on the basis of a six-volume study published in the spring of 1957, that authority for regulating installment credit was inadvisable and that the use of general controls was adequate to deal with unstabilizing credit developments. This is in contrast to the views of the Board expressed in a more comprehensive statement submitted to the Patman committee 5 years earlier, that consumer credit is relatively unresponsive to general credit instruments and for this reason selective regulation provides a helpful supplement to general monetary controls.

An additional factor reducing the effectiveness of Federal Reserve policy which has been stressed in recent years is the growth of financial intermediaries, such as life-insurance companies, building and loan associations, savings banks, investment companies, and pension funds. In 1955 life-insurance companies, savings and loan associations, and mutual savings banks acquired over two-thirds of the more than $16 billion increase in the non-farm-mortgage debt. Accordingly, some students of monetary policy have argued for selective control over housing credit as well as over installment credit.

The monetary authorities had a difficult course to steer with respect to credit policy in 1956. Once they had failed to adopt stronger measures in 1955, they were in the proverbial position of holding a bear by the tail during the following year and a half. On the one hand, there was the risk that a more liberal policy with respect to the availability of bank reserves might accelerate price rises, especially in "bottleneck" sectors of the economy. On the other hand, if the policy became much more restrictive, there was the danger of initiating a downward spiral in business activity since certain of the key sectors which had ushered in the boom had been showing considerable weakness for some time. Nevertheless, with the economy continuing to operate near capacity levels—despite some uncertainties about its general direction—and with prices and wage rates moving upward, the Open Market Committee felt that as a general policy it could not relax in its efforts at restricting the availability of bank reserves. Open-market operations were so conducted that the security holdings of the System had increased by only $160 million during 1956. The money supply grew at the rate of only 1 percent as compared to a 2.8 percent rise in 1955. However, the rate of turnover of demand deposits in centers outside of New York City increased 8 percent in 1956.

One may justifiably view with favor the determination of the Federal Reserve not to relax restraints in 1956 and in the first half of 1957, but there is much less justification for regarding favorably the policies pursued through the summer and fall of 1957. In public statements by Federal Reserve officials, in testimony at congressional hearings, and through policy decisions such as raising the discount

rate one-half of 1 percentage point, i. e., to 3½ percent in August, the monetary authorities appeared to show little concern about the increasing signs that the boom might end in the not-too-distant future. In the fall and almost up to mid-November, when the discount rate was lowered from 3½ to 3 percent, giving public notice that the Federal Reserve regarded the immediate problem ahead as not inflation but business contraction, presidents of the Reserve banks and members of the Board of Governors of the System were making speeches that inflation was still the No. 1 economic problem and it would be a great mistake to relax credit restraint.

In the light of the vehemence and the frequency with which Federal Reserve officials publicly stressed during the first 10 months of 1957 the necessity for continuing monetary restraint, it comes as a surprise to read the record of the 1957 meetings of the Open Market Committee. During almost all of the 18 meetings held throughout the year there appeared to be an absence of that confidence in the business outlook and in the continuation of inflationary pressures which was manifested in public statements by top spokesmen for the System. The contrast between the record of the deliberations of the Open Market Committee and the public statements and actions of the Federal Reserve requires explanation. Similarly, the relatively sharp rise in the discount rate in August, when business expansion was grinding to a halt, is also in need of a more satisfactory explanation than has been thus far advanced by the monetary authorities. It is safe to predict that long after the events of 1957 have passed, economists will still seek the answer to these two questions.

In explaining the August 1957 rise in the discount rate, the Chairman of the Federal Reserve Board recently stated that the change was necessary for technical reasons, but what he appeared to ignore was the fact that the sharp hike in the rate was widely interpreted as indicating that the monetary authorities regarded the intensification of inflationary pressures and the need for continuation of monetary restraint as the immediate issue facing the country. That a change in the discount rate is regarded as a signal to the public of a shift in Federal Reserve policy was expressly stated by the Board of Governors of the System when it lowered the rate in November. If it was a public signal in November, it must also have been one in August.

If the inadequacies of the Federal Reserve in 1955 may justifiably be said to have encouraged subsequent inflationary developments, the miscalculations in the summer and fall of 1957 may be said to have contributed to the sharpest business decline in the postwar period.

The misunderstanding with respect to the unusually sharp rise in the discount rate in August, and the fact that meetings of the Open Market Committee are publicly reported as late as a year after they have taken place, call for exploration of improved methods for providing the public with a clearer understanding of Federal Reserve policy changes through prompt publication of explanatory statements.

The 1955–57 boom, followed by the sharpest recession in the postwar period, and the current signs of resumption of expansion with the probable renewal of inflationary pressures, all emphasize the necessity of a fundamental reexamination of our financial system with a view to increasing the effectiveness of monetary policy in a stabilization program.

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OCTOBER 10, 1958.—Ordered to be printed under authority of the order of the Senate of August 24, 1958

Mr. FULBRIGHT, from the Committee on Banking and Currency, submitted the following

REPORT

CHAPTER I. THE PERIOD OF TRANSITION, 1951–52

MONETARY POLICY AND DEBT MANAGEMENT

When the Treasury-Federal Reserve accord was reached on March 4, 1951, it was hailed as an important development marking the end of a decade during which monetary policy had been subordinated to debt management policy. Freed from the necessity of supporting the Government security market at fixed or pegged prices, the monetary authorities would henceforth be in a position to use more effectively the tools of credit policy for promoting economic stability.

There had been mounting criticism for several years prior to the accord on the extent to which debt management considerations by the Treasury continued to dominate Federal Reserve monetary policies. These views were thoroughly aired during the hearings of the Douglas Subcommittee on Monetary, Credit, and Fiscal Policies which opened in September 1949, and in the collection of statements submitted to the subcommittee by Government officials, bankers, economists, and others, published in November 1949. There followed in January 1950 the subcommittee's report which recommended that "an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of the principal methods used to achieve the purposes of the Employment Act." [1] It went on to state:

> Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability. The vigorous use of a restrictive

[1] Monetary, Credit, and Fiscal Policies: Report of the Subcommittee on Monetary, Credit, and Fiscal Policies, Joint Committee on the Economic Report, 81st Cong., 2d sess., 1950, S. Doc. No. 129, p.1.

> monetary policy as an anti-inflation measure has been inhibited since the war by considerations relating to holding down the yields and supporting the prices of United States Government securities. As a long-run matter, we favor interest rates as low as they can be without inducing inflation, for low interest rates stimulate capital investment. But we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes.[2]

The subcommittee rejected, for the reasons given below, the notion held by some groups that for stabilization purposes "little or no reliance should be placed on monetary policy and that we should rely exclusively on other measures, such as fiscal policy:"

> (1) It is highly doubtful that fiscal policy would be powerful enough to maintain stability in the face of strong destabilizing forces even if monetary policy were neutral, and a conflicting monetary policy could lessen still further the effectiveness of fiscal policy. (2) Monetary policy is strong precisely where fiscal policy is weakest; it is capable of being highly flexible. It can be altered with changes in economic conditions on a monthly, daily, or even hourly basis. (3) It is a familiar instrument of control and thoroughly consistent with the maintenance of our democratic government and our competitive free-enterprise system. It is certainly much to be preferred over a harness of direct controls. (4) Our monetary history gives little indication as to how effectively we can expect appropriate and vigorous monetary policies to promote stability, for we have never really tried them.[3]

The report stressed that, to be effective, monetary management must be characterized by timely, vigorous, and flexible actions:

> The essential characteristic of a monetary policy that will promote general economic stability is its timely flexibility. To combat deflation and promote recovery, the monetary authorities must liberally provide the banking system with enhanced lending power, thereby tending to lower interest rates and increase the availability of credit. To retard and stop inflation they must restrict the lending power of banks, thereby tending to raise interest rates and to limit the availability of credit for private and Government spending. And these actions must be taken promptly if they are to be most effective.[4]

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[2] Ibid., p. 2.
[3] Ibid., p. 18.
[4] Ibid., p. 19.

TABLE 1.—*Indexes of industrial production, wholesale and consumer prices, 1950–52*

[1947–49=100]

Month	Industrial production [1]	Wholesale prices	Consumer prices	Month	Industrial production [1]	Wholesale prices	Consumer prices
1950—January	100	97.7	100.6	1951—July	119	114.2	110.9
February	99	98.3	100.4	August	118	113.7	110.9
March	102	98.5	100.7	September	118	113.4	111.6
April	106	98.5	100.8	October	118	113.7	112.1
May	110	99.6	101.3	November	119	113.6	112.8
June	112	100.2	101.8	December	119	113.5	113.1
July	115	103.0	102.9	1952—January	121	113.0	113.1
August	120	105.2	103.7	February	121	112.5	112.4
September	120	107.1	104.4	March	121	112.3	112.4
October	121	107.7	105.0	April	120	111.8	112.9
November	120	109.3	105.5	May	119	111.6	113.0
December	122	112.1	106.9	June	118	111.2	113.4
1951—January	122	115.0	108.6	July	115	111.8	114.1
February	122	116.5	109.9	August	123	112.2	114.3
March	122	116.5	110.3	September	129	111.8	114.1
April	122	116.3	110.4	October	130	111.1	114.2
May	122	115.9	110.9	November	133	110.7	114.3
June	121	115.1	110.8	December	133	109.6	114.1

[1] Seasonally adjusted.

Source: Board of Governors of the Federal Reserve System and U. S. Department of Labor.

Fourteen months elapsed between the publication of the Douglas committee report and the accord. During this period, the outbreak of the Korean war in June 1950 touched off strong inflationary pressures. The abnormally heavy buying by consumers and business firms in anticipation of possible future shortages resulted in a sharp increase in prices. Between June 1950 and March 1951, wholesale commodity prices rose by about 16 percent. During these 9 months, the Federal Reserve System increased its holdings of Government securities by over $4 billion, thus increasing bank reserves which facilitated the unusual expansion of bank loans by nearly $10 billion.

Public hearings and committee reports helped to focus attention on the desirability of greater Federal Reserve independence. But it was not until developments after the Korean war made it especially evident that credit expansion would continue to feed the upward price spiral, so long as the Federal Reserve System purchased large quantities of Government securities at pegged prices, that the Treasury finally agreed to an arrangement giving monetary policy a coordinate role with debt management policy.

THE ACCORD

The Treasury and the Federal Reserve System announced on March 4, 1951, that they had—

> reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize the monetization of the public debt.

In accordance with this agreement, holders of the 2½ percent restricted bonds of 1967–72 in the amount of $19.7 billion were to be given the opportunity to exchange them for a nonmarketable 2¾-percent 29-year bond, convertible at the option of the holder into a 1½-percent 5-year marketable Treasury note. This was designed to encourage the holding of long-term bonds and thus curb debt monetization.

The most important phase of the agreement directed toward minimizing the monetization of the debt was that the Reserve System would immediately discontinue purchases of Government securities at pegged prices at the option of the market. It was agreed, however, that a limited volume of open-market purchases would be made while the long-term bonds were being exchanged. This meant that disposal by banks and other investors of such securities would be governed by the demand in the market without Federal Reserve open-market support. In response to market forces, short-term interest rates were expected to fluctuate around the Federal Reserve discount rate which, except for unforeseen developments, would remain at 1¾ percent for the rest of the year. Under these circumstances, the Federal Reserve expected to influence the availability of credit because individual member banks would have to come to the discount window and borrow at the discount rate to maintain or increase their reserves.

Finally, it was agreed that there would be more frequent conferences between the Treasury and Federal Reserve officials and staff to work more closely on a joint program of Government financing as well as in the maintenance of orderly markets for Government securities.

The significance of the accord lies in the fact that it paved the way for the Federal Reserve to exercise greater freedom in the use of its major instruments of credit policy for promoting economic stability. So long as the rigid support of the Government security market continued, open-market operations, the discount rate, and reserve requirements—the three principal methods for regulating the volume of bank credit and the money supply—could not be employed effectively. They could only operate effectively in an inflationary period if they were free to restrict the availability of bank reserves. But the initiative in changing member bank reserves when the Government security market is pegged rested largely with the holders of these securities. In a period of a great rise in the demand for credit, commercial banks and nonbank investors, a large part of whose assets were in the form of Government securities at low yields, found it more attractive to dispose of substantial amounts of these securities and place their funds in higher-earning loans.

From the end of June 1950 to the end of February 1951, commercial banks sold United States Government securities in the amount of $6.7 billion, insurance companies $1.1 billion, and mutual savings banks nearly $1 billion. The Federal Reserve banks purchased about $4 billion. During the 8-month period, member bank reserves increased by over $3 billion despite a loss in gold of nearly $2.5 billion. About $2 billion of member bank reserves were absorbed by the Federal Reserve increasing requirements in January and February 1951 by 2 percentage points on demand deposits and 1 percentage point on time deposits.

TABLE 2.—*Bond yields and interest rates, 1950–52*

[Percent per annum]

Period	U. S. Government securities			Corporate bonds (Moody's)		Common stock yields, 200 stocks (Moody's)	High-grade municipal bonds (Standard & Poor's)	Average rate on short-term bank loans to business, selected cities	Prime commercial paper, 4 to 6 months	Federal Reserve bank discount rate
	3-month Treasury bills	9 to 12 month issues [1]	Taxable bonds (long term) [2]	Aaa	Baa					
1950—January	1.090	1.12	2.20	2.57	3.24	6.28	2.08	----------	1.31	1.50
February	1.125	1.15	2.24	2.58	3.24	6.24	2.06	----------	1.31	1.50
March	1.138	1.16	2.27	2.58	3.24	6.16	2.07	2.60	1.31	1.50
April	1.159	1.17	2.30	2.60	3.23	5.98	2.08	----------	1.31	1.50
May	1.166	1.18	2.31	2.61	3.25	5.79	2.07	----------	1.31	1.50
June	1.174	1.23	2.33	2.62	3.28	6.17	2.09	2.68	1.31	1.50
July	1.172	1.23	2.34	2.65	3.32	6.17	2.09	----------	1.31	1.50
August	1.211	1.26	2.33	2.61	3.23	6.39	1.90	----------	1.42	[3] 1.75
September	1.315	1.33	2.36	2.64	3.21	6.22	1.88	2.63	1.65	1.75
October	1.329	1.40	2.38	2.67	3.22	6.49	1.82	----------	1.72	1.75
November	1.364	1.47	2.38	2.67	3.22	6.80	1.79	----------	1.69	1.75
December	1.367	1.46	2.39	2.67	3.20	6.57	1.77	2.84	1.72	1.75
1951—January	1.387	1.47	2.39	2.66	3.17	6.32	1.62	----------	1.86	1.75
February	1.391	1.60	2.40	2.66	3.16	6.27	1.61	----------	1.96	1.75
March	1.422	1.79	2.47	2.78	3.22	6.40	1.87	3.02	2.04	1.75
April	1.520	1.89	2.56	2.87	3.34	6.18	2.05	----------	2.11	1.75
May	1.578	1.85	2.63	2.88	3.40	6.35	2.09	----------	2.16	1.75
June	1.499	1.79	2.65	2.94	3.49	6.55	2.22	3.07	2.31	1.75
July	1.593	1.74	2.63	2.94	3.53	6.20	2.18	----------	2.31	1.75
August	1.644	1.70	2.57	2.88	3.51	5.86	2.04	----------	2.26	1.75
September	1.646	1.71	2.56	2.84	3.46	5.91	2.05	3.06	2.19	1.75
October	1.608	1.74	2.61	2.89	3.50	6.02	2.08	----------	2.22	1.75
November	1.608	1.68	2.66	2.96	3.56	5.78	2.07	----------	2.25	1.75
December	1.731	1.77	2.70	3.01	3.61	5.55	2.10	3.27	2.30	1.75
1953—January	1.688	1.75	2.74	2.98	3.59	5.53	2.10	----------	2.38	1.75
February	1.574	1.70	2.71	2.93	3.53	5.73	2.04	----------	2.38	1.75
March	1.658	1.69	2.70	2.96	3.51	5.49	2.07	3.45	2.38	1.75
April	1.623	1.60	2.64	2.93	3.50	5.77	2.01	----------	2.35	1.75
May	1.710	1.66	2.57	2.93	3.49	5.65	2.05	----------	2.31	1.75
June	1.700	1.74	2.61	2.94	3.50	5.45	2.10	3.51	2.31	1.75
July	1.824	1.89	2.61	2.95	3.50	5.39	2.12	----------	2.31	1.75
August	1.876	1.94	2.70	2.94	3.51	5.46	2.22	----------	2.31	1.75
September	1.786	1.95	2.71	2.95	3.52	5.56	2.33	3.49	2.31	1.75
October	1.783	1.84	2.74	3.01	3.54	5.56	2.42	----------	2.31	1.75
November	1.862	1.89	2.71	2.98	3.53	5.28	2.40	----------	2.31	1.75
December	2.126	2.03	2.75	2.97	3.51	5.13	2.40	3.51	2.31	1.75

[1] Includes certificates of indebtedness and selected note and bond issues.

[2] 2½ percent bonds, 15 years and over prior to April 1952 and 12 years and over beginning April 1952.

[3] Effective Aug. 21, 1950.

Source: Board of Governors of the Federal Reserve System, Treasury Department, Moody's Investors Service, and Standard and Poor's Corp.

FLEXIBLE MONETARY POLICY AND RISING INTEREST RATES

As was expected, abandonment of the rigid support policy resulted in an increase in bond yields and in interest rates. The yields on Federal securities rose moderately from April 1951 to mid-1952—a rise that was much less than was anticipated in some quarters. During this period yields on long-term bonds ranged from 2.56 to 2.61, 90-day bills from 1.52 to 1.70, and Aaa corporate bonds from 2.87 to 2.94.

Could a rise of interest rates of these magnitudes have any significant effect on the expansion of bank credit? The monetary authorities who argued for a more flexible credit policy maintained that even moderate increases in interest rates would serve to curtail the volume of bank credit. This view is explained at length in statements prepared by the Federal Reserve for the Patman Subcommittee on General Credit Control and Debt Management.[5] According to this theory, the monetary authorities can limit bank reserves by selling Government securities or by limiting the amount of securities purchased and permitting their prices to adjust to investor demands in the market. A rise in yield occurs in either case. The increasing yield checks the tendency of banks and other financial institutions who are inclined to sell Government securities from switching to such other investments as business loans or mortgages. They are reluctant to sell Government securities because of the capital loss involved. Moreover, institutional rigidities which keep rates on other assets from rising while the yield on Government securities increases make the holding of Governments relatively more attractive. Then too, in an unpegged market, banks and financial institutions become more cautious in disposing of Federal securities because of the increasing uncertainty about future security prices and yields. As a result of these reactions by lending institutions, there is a reduction in the volume of credit extended to borrowers, even though the latter may not be disposed to lessen their demand for funds because of increasing interest rates. In short, according to this theory, a more flexible monetary policy can succeed in limiting the availability of credit even without an appreciable rise in interest rates.[6]

To what extent did developments in the money market after the accord support this viewpoint? In the first place, it is essential to establish whether the sale of Government securities by lending institutions was curtailed. Secondly, even if this occurred, did the change take place because the price of Governments fell below par, i. e., the rise in interest rates, or because of other factors that influenced the demand and supply of credit?

Examination of data on changes in Government security holdings since the accord does not indicate uniformity of reaction to rising interest rates by lending institutions. For example, from mid-1951 to mid-1952, insurance companies and mutual savings banks continued to dispose of large amounts of Government securities while

[5] Monetary Policy and Management of the Public Debt: Replies to questions and other material for the use of the Subcommittee on General Credit Control and Debt Management, Joint Committee on the Economic Report, 82d Cong., 2d sess., 1952, S. Doc. No. 123, pt. I, p. 368 ff. and especially pp. 371–373 and 380–383.

[6] The view that under modern conditions even small changes in interest rates can have a considerable restrictive influence on bank loans has been expounded by Robert V. Roosa, now vice president of the Federal Reserve Bank of New York. His article, Interest Rates and the Central Bank, has become the standard reference for the exposition of this viewpoint. See Money, Trade, and Economic Growth, in honor of John Henry Williams, pp. 270–295. The Macmillan Co., New York, 1951.

commercial banks increased their holdings of short-term securities substantially. It would seem that supporters of the view that a more restrictive monetary policy, accompanied by a moderate increase in interest rates and culminating in a lessening of the availability of credit, cannot obtain comfort from the fact that institutional holders of long-term Government securities, such as insurance companies and savings banks, did not stop sales from their portfolios. However, they can point out that the rate of disposal of Governments by these institutions did definitely slacken after the accord, a change that was presumably influenced by the fact that sales had to be made at market and not at pegged rates.

TABLE 3.—*Estimated ownership of Federal obligations, 1950–57*

[Par values [1] in billions of dollars]

End of month	Total Federal securities outstanding [2]	U. S. Government investment accounts	Held by banks			Held by private nonbank investors						
			Total	Commercial banks [3]	Federal Reserve banks	Total	Individuals [4]	Insurance companies	Mutual savings banks	Corporations [5]	State and local governments [6]	Miscellaneous investors [7]
1950—June	257.4	37.8	83.9	65.6	18.3	135.6	67.4	19.8	11.6	18.4	8.7	9.7
December	256.7	39.2	82.6	61.8	20.8	134.9	66.3	18.7	10.9	19.7	8.8	10.5
1951—June	255.3	41.0	81.4	58.4	23.0	132.9	65.4	17.1	10.2	20.1	9.4	10.7
December	259.5	42.3	85.4	61.6	23.8	131.8	64.6	16.5	9.8	20.7	9.6	10.6
1952—June	259.2	44.3	84.0	61.1	22.9	130.8	64.8	15.7	9.6	18.8	10.4	11.6
December	267.4	45.9	88.1	63.4	24.7	133.4	65.1	16.1	9.5	19.9	11.1	11.7
1953—June	266.1	47.6	83.6	58.8	24.7	135.0	66.0	16.0	9.5	18.7	12.0	12.8
December	275.2	48.3	89.6	63.7	25.9	137.3	64.8	15.8	9.2	21.6	12.7	13.2
1954—June	271.3	49.3	88.7	63.6	25.0	133.3	64.8	15.3	9.1	16.6	13.9	13.7
December	278.8	49.6	94.1	69.2	24.9	135.1	63.6	15.0	8.8	19.2	14.4	13.9
1955—June	274.4	50.5	87.1	63.5	23.6	136.7	65.4	14.8	8.7	18.7	14.7	14.4
December	280.8	51.7	86.8	62.0	24.8	142.3	65.6	14.3	8.5	23.3	15.1	15.6
1956—June	272.8	53.5	80.8	57.1	23.8	138.5	67.5	13.3	8.4	17.4	15.7	16.3
December	276.7	54.0	84.2	59.3	24.9	138.5	67.1	12.8	8.0	18.6	16.1	16.1
1957—June	270.6	55.6	78.9	55.8	23.0	136.2	67.4	12.3	7.9	15.7	16.9	16.1
December	275.0	55.2	83.2	58.9	24.2	136.6	66.6	12.0	7.6	16.9	17.0	16.5

[1] United States savings bonds, series A–F and J, are included at current redemption value.

[2] Securities issued or guaranteed by the U. S. Government, excluding guaranteed securities held by the Treasury.

[3] Consists of commercial banks, trust companies, and stock savings banks in United States and in Territories and island possessions.

[4] Includes partnerships and personal trust accounts. Nonprofit institutions and corporate pension trust funds are included under "Miscellaneous investors."

[5] Exclusive of banks and insurance companies.

[6] Consists of trust, sinking, and investment funds of State and local governments and their agencies, and Territories and island possessions.

[7] Includes savings and loan associations, nonprofit institutions, corporate pension trust funds, dealers and brokers, and investments of foreign balances and international accounts in this country.

Source: Treasury Department.

THE MONEY SUPPLY

The rise in interest rates did not appear to have any deterrent effect on the money supply. The volume of money, measured by demand deposits and currency outside banks, which had risen by $3.2 billion from June 1950 to March 1951, increased by $5.8 billion in the comparable period of 1951–52. The increase in money supply took place despite a slackening in the expansion of bank loans. Total bank loans which had risen by $10 billion during the 9 months prior to the accord increased by less than one-third in the 9 months ending March 1952, due largely to the slackening in business, real estate, and consumer loans. Two factors were mainly responsible for the change in the relationship between bank loans and the money supply. In the earlier period the expansion of bank loans was accompanied by a very substantial drop in the holdings of Government securities by the banking system and by a sizable outflow of gold from the country; in the later period the rise in bank loans was accompanied by an increase in bank holdings of Government securities and by an inflow of gold into the country.

TABLE 4.—*Deposits and currency, 1950–52*

[Billions of dollars]

End of period	Deposits and currency				
	Total [1]	Demand deposits and currency			Time deposits [3]
		Total	Demand deposits adjusted [2]	Currency outside banks	
1950—January	169.7	110.9	86.4	24.5	58.7
February	168.2	109.2	84.5	24.7	59.0
March	167.1	107.8	83.2	24.6	59.3
April	168.4	108.9	84.3	24.6	59.5
May	169.2	109.7	85.0	24.7	59.5
June	170.0	110.2	85.0	25.2	59.7
July	170.2	110.9	86.5	24.4	59.4
August	171.0	111.9	87.4	24.5	59.1
September	171.6	112.5	88.0	24.5	59.0
October	172.8	113.8	89.2	24.6	59.0
November	173.9	115.2	90.3	24.9	58.7
December	176.9	117.7	92.3	25.4	59.2
1951—January	175.2	116.2	91.6	24.6	59.0
February	174.2	115.2	90.6	24.6	59.0
March	172.5	113.4	89.0	24.4	59.1
April	173.3	114.1	89.5	24.6	59.2
May	173.7	114.4	89.5	24.9	59.3
June	174.7	114.7	89.0	25.8	59.9
July	175.8	115.8	90.7	25.1	60.0
August	177.0	116.7	91.4	25.3	60.3
September	177.9	117.4	92.0	25.4	60.5
October	181.6	120.7	95.0	25.7	60.9
November	182.7	122.1	96.3	25.8	60.6
December	186.0	124.5	98.2	26.3	61.5
1952—January	185.2	123.5	97.9	25.6	61.7
February	183.4	121.3	95.7	25.6	62.0
March	182.9	120.5	94.8	25.7	62.4
April	183.8	121.0	95.1	25.9	62.7
May	184.4	121.3	95.3	26.0	63.0
June	184.9	121.2	94.8	26.5	63.7
July	185.8	121.9	95.7	26.2	63.8
August	186.2	122.1	95.8	26.3	64.1
September	187.4	123.0	96.4	26.6	64.5
October	190.2	125.3	98.6	26.7	64.9
November	191.6	126.8	99.4	27.4	64.8
December	194.8	129.0	101.5	27.5	65.8

[1] Includes holdings of State and local governments, but excludes U. S. Government deposits.
[2] Includes demand deposits, other than interbank and U. S. Government, less cash items in process of collection.
[3] Includes deposits in commercial banks, mutual savings banks, and Postal Savings System, but excludes interbank deposits.

Source: Board of Governors of the Federal Reserve System.

Total member bank reserves had increased by $3.1 billion from June 1950 to March 1951, but the raising of reserve requirements in January 1951 resulted in only $1.1 billion increase in the reserves available for credit expansion by March 1951. In the year ending March 1952 the reserves available for credit expansion had increased by $1.3 billion. The difference between the two periods was that prior to March 1951, very large Federal Reserve purchases of Government securities more than offset a substantial outflow of gold to increase bank reserves, while during the year ending March 1952 Reserve bank holdings of Government securities showed little net change with additional reserves being supplied by a gold inflow.

TABLE 5.—*Loans and investments of all commercial banks, 1950–52* [1]

[Billions of dollars]

End of period [2]	Total loans and investments	Loans		Investments		
		Total [3]	Business [4]	Total	U.S. Government obligations	Other securities
1950—January	121.2	42.9	17.2	78.3	68.0	10.3
February	120.6	43.1	17.2	77.5	67.1	10.4
March	120.3	43.7	17.1	76.6	65.8	10.8
April	120.3	43.8	16.8	76.5	65.5	11.0
May	121.2	44.1	16.7	77.1	66.1	11.0
June	121.8	44.8	16.9	77.0	65.8	11.2
July	122.3	46.0	17.3	76.4	65.0	11.4
August	123.3	47.3	18.3	76.0	64.2	11.8
September	123.6	48.9	19.4	74.6	62.5	12.1
October	124.5	49.9	20.0	74.6	62.5	12.1
November	125.4	51.5	21.1	73.8	61.7	12.1
December	126.7	52.2	21.9	74.4	62.0	12.4
1951—January	125.1	52.7	22.3	72.4	60.0	12.4
February	125.0	53.5	23.1	71.5	59.1	12.4
March	125.7	54.4	23.7	71.4	58.8	12.6
April	125.4	54.4	23.6	71.1	58.5	12.6
May	125.1	54.5	23.5	70.6	58.1	12.5
June	126.0	54.8	23.7	71.2	58.5	12.7
July	126.1	54.6	23.4	71.5	58.7	12.8
August	127.0	55.2	23.9	71.8	59.1	12.7
September	128.6	56.0	24.5	72.6	59.7	12.9
October	130.5	56.8	25.0	73.8	60.9	12.9
November	131.9	57.3	25.3	74.6	61.6	13.0
December	132.6	57.7	25.9	74.9	61.5	13.3
1952—January	132.8	57.5	25.6	75.3	62.0	13.3
February	132.2	57.6	25.6	74.7	61.3	13.4
March	132.5	57.8	25.8	74.7	61.1	13.6
April	132.3	58.2	25.2	74.2	60.5	13.7
May	133.1	58.5	24.9	74.5	60.7	13.8
June	134.4	59.2	25.3	75.2	61.2	14.0
July	136.8	59.7	25.1	77.0	62.9	14.1
August	136.6	60.2	25.5	76.4	62.0	14.4
September	137.1	61.2	26.2	75.9	61.6	14.3
October	139.4	62.4	26.9	77.1	62.9	14.2
November	141.7	63.4	27.5	78.3	64.1	14.2
December	141.6	64.2	27.9	77.5	63.3	14.1

[1] Excludes mutual savings banks.
[2] June and December figures are for call dates. Other monthly data are for the last Wednesday of the month.
[3] Data are shown net. Includes commercial and industrial loans, agricultural loans, loans on securities, real estate loans, loans to banks, and "other loans," some of which represent consumer credit.
[4] Data are shown gross, i. e., before deduction of valuation reserves. For months other than June and December data are estimated on the basis of reported data for all insured commercial banks and for weekly reporting member banks.

Source: Board of Governors of the Federal Reserve System.

In considering monetary policy after the accord, it is necessary, of course, to refer to the underlying business conditions that were influencing the demand for funds as well as the factors influencing their supply. The accord took place at a time when inflationary develop-

ments had about reached their greatest intensity. Few would deny that continuous support purchases of Government securities at pegged prices had made the Federal Reserve System an "engine of inflation" during the 9 months after the outbreak of the Korean war. But the extent to which the removal of continuous support purchases of Government securities was of strategic importance in the weakening of inflationary pressures after March 1951 is a debatable question. There are those who emphasize the importance of the change in business conditions, particularly the cessation of the abnormally heavy forward buying by consumers and business firms when the anticipated shortages did not develop. To be sure, they grant that the shift in monetary policy exerted some anti-inflation influence in 1951, as was the case also with direct controls over prices and wages by the Federal Government, and of the selective controls over real state credit, consumer credit, and credit for security markets.[7]

ECONOMIC DEVELOPMENTS

That inflationary pressures had lessened after March 1951 is evident from the indexes of industrial production and of wholesale prices. The former which had climbed from 112 in June 1950 to 122 by December continued at the same level through May 1951, dropped to 118 by August and more or less remained at this level for the rest of the year. The latter rose from 100.2 in June 1950 to 116.5 in March 1951, declined to 113.7 in August, stabilized at this level for the remainder of the year, and continued to drift downward in 1952.

The gross national product which rose from an annual rate of $274.4 billion in the second quarter of 1950 to $317.8 billion in the first quarter of 1951—an increase of 15.8 percent—reached $341 billion in the first quarter of 1952—an increase of only 7.3 percent during the year. In the earlier period the pronounced increase in GNP was due primarily to the sharp rise in consumer expenditures and in business inventories; in the later period defense expenditures showed a very marked rise while the rate of accumulation of business inventories fell off sharply and consumer spending at first declined and then moved upward gradually. The relative influence of the various sectors of the economy on the changes in the pace of total national output before and after the accord can be seen from the figures for the major components of GNP from quarter to quarter.

[7] In support of their position that the accord played a more powerful role in curbing inflationary pressures than their critics have been prepared to grant, Federal Reserve officials have argued that the mere fact of ceasing to support long-term Governments had the effect of shrinking considerably the liquidity of the economy. As was expected, this decrease in the general liquidity resulted in the banks enlarging their holdings of short-term United States securities and of nonbank institutional holders greatly decreasing the rate of their disposals of long-term Government securities. For the same reason, there was an increase in the demand for cash balances—as the rise in the money supply after the accord appeared to indicate.

The critics, on the other hand, who question the substantial influence of the accord in curbing inflation, cite in support of their view the fact that bank loans continued to grow, insurance companies and savings banks continued to dispose of Government securities in favor of other assets, and the expansion of currency and deposits was more rapid after the change in policy than before. For the latter view, see Charles R. Whittlesey, Old and New Ideas on Reserve Requirements, Journal of Finance, May 1953, pp. 193–194; also James Tobin, Monetary Policy and the Management of the Public Debt: The Patman Inquiry, Review of Economics and Statistics, May 1953, p. 124.

For an interpretation of the period which indicates that general market conditions were chiefly responsible for the downward movement of wholesale prices since early in 1951, see Bert G. Hickman, The Korean War and United States Economic Activity, 1950–52, Occasional Paper 49, National Bureau of Economic Research, Inc., 1955.

TABLE 6.—*Gross national product, seasonally adjusted at annual rates, 1950–52*

[Billions of dollars]

	1950				1951				1952			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Gross national product	265.8	274.4	293.2	304.3	317.8	326.4	333.8	338.1	341.0	341.3	347.0	358.6
Personal consumption expenditures	185.7	189.9	204.4	200.1	211.5	205.5	208.8	213.4	214.6	217.7	219.6	227.2
Durable goods	26.8	27.9	35.5	31.2	33.0	28.0	28.5	28.4	27.7	29.1	27.5	32.1
Nondurable goods	96.2	97.7	103.3	102.0	110.2	108.1	109.5	112.7	113.3	113.9	115.9	117.2
Services	62.6	64.3	65.7	66.9	68.3	69.4	70.8	72.3	73.6	74.7	76.2	77.9
Gross private domestic investment	39.8	46.9	51.1	61.4	56.9	61.6	56.3	51.0	52.2	45.6	49.1	52.6
New construction	21.6	23.6	25.6	25.3	25.7	25.0	24.5	24.5	25.2	25.4	25.4	26.1
Residential nonfarm	12.2	13.8	15.4	14.4	14.1	12.5	11.8	12.1	12.4	12.7	12.8	13.4
Other	9.4	9.8	10.3	10.9	11.6	12.5	12.7	12.4	12.8	12.7	12.6	12.7
Producers' durable equipment	15.7	18.4	20.6	21.1	20.7	21.3	21.6	21.5	21.9	22.4	19.4	21.2
Change in business inventories: total	2.5	4.9	4.9	15.0	10.5	15.2	10.2	4.9	5.1	−2.2	4.3	5.3
Nonfarm only	2.2	4.2	3.8	13.8	9.3	14.0	9.1	3.8	4.0	−3.3	3.4	4.7
Net foreign investment	−.9	−2.3	−3.0	−2.7	−2.3	−.6	1.9	1.9	2.0	.9	−1.7	−1.9
Government purchases of goods and services	41.2	39.9	40.6	45.5	51.6	59.9	66.8	71.8	72.2	77.1	80.0	80.7
Federal	21.9	20.6	20.8	25.2	30.8	38.4	44.9	49.7	49.6	54.0	56.7	57.0
National security	17.0	17.1	17.8	22.2	27.6	34.8	41.1	45.3	45.3	49.0	50.0	51.3
Other	5.2	3.8	3.2	3.3	3.5	3.9	4.4	4.9	4.7	5.4	7.0	6.0
Less Government sales	.3	.2	.2	.3	.3	.3	.6	.5	.4	.4	.3	.3
State and local	19.3	19.3	19.8	20.3	20.9	21.6	21.9	22.1	22.5	23.1	23.2	23.7

Source: Department of Commerce.

One of the immediate effects of the outbreak of the Korean war was the marked rise in consumer expenditures and the sizable drop in personal savings. From the second to the third quarter of 1950 personal consumption expenditures increased at an annual rate of $14.5 billion, or 7.1 percent. More than one-half of the increase was in consumer durable goods. This pronounced rise was followed by a sharp increase in business inventories in the last 3 months of the year, a change from an annual rate of $4.9 billion in the third to $15 billion in the fourth quarter.

In the first quarter of 1951 consumer expenditures increased by $11.4 billion over the final quarter of 1950. During the next 3 months they dropped by $6 billion with most of the decline in expenditures for consumer durables. Spending for consumer durables continued at the sharply reduced second quarter level through the first 3 months of 1952. Investment in business inventories which reached a record annual rate of $15.2 billion in the second quarter of 1951 dropped to $4.9 billion in the fourth and to minus $2.2 billion by the second quarter of 1952.[8]

Residential nonfarm construction expenditures which had reached an annual rate of $15.4 billion in the third quarter of 1950 dropped to a rate of $11.8 billion a year later.

[8] Federal Reserve officials stress the view that the accord played a major role in changing the climate of expectations in the money market and in general market conditions. The flight of "hot money" from the dollar before the accord, and reflected in gold exports, was followed by the cessation of the flight of gold after the accord. Moreover, it was an important factor in changing inflationary psychology with a consequent shift in consumer expenditures and business inventories.

TABLE 7.—*Disposition of disposable personal income, 1950–52*

[Seasonally adjusted quarterly totals at annual rates]

[Billions of dollars]

Period	Disposable personal income	Personal consumption expenditures	Personal saving	Saving as percent of disposable personal income
1950—1st quarter	200.9	185.7	15.2	7.6
2d quarter	201.7	189.9	11.8	5.9
3d quarter	210.2	204.4	5.8	2.8
4th quarter	217.7	200.1	17.6	8.1
1951—1st quarter	219.8	211.5	8.3	3.8
2d quarter	226.4	205.5	20.9	9.2
3d quarter	229.5	208.8	20.7	9.0
4th quarter	233.8	213.4	20.4	8.8
1952—1st quarter	232.1	214.6	17.5	7.5
2d quarter	235.6	217.7	17.9	7.6
3d quarter	241.1	219.6	21.5	9.0
4th quarter	245.6	227.2	18.4	7.4

Source: Department of Commerce.

Thus, while outlays for consumer durable goods and housing together with inventory investment were major stimuli in the inflationary developments during the second half of 1950 and in early 1951, by mid-1951 these sectors were a restraining influence upon inflationary pressures. At the same time that these contractive forces were operating, defense outlays had stepped up sharply. National security expenditures which were at an annual rate of $22.2 billion in the final quarter of 1950 more than doubled by the final quarter of 1951. Most of the rise in gross national product during this period originated from this source.

REVIVAL OF THE DISCOUNT MECHANISM

If we must largely attribute the subsidence of inflationary pressures during the first year after the accord to the reduction in spending by consumers for durable goods and to the downward adjustment of business inventories, this does not signify that the more flexible credit policy was not a salutary development. While there are differences of opinion as to how much of an anti-inflationary influence the monetary authorities actually were or could be after March 1951, it can hardly be questioned that with the turning away from the rigid support of Government security prices the way was paved for open-market operations and the discount mechanism to become more effective complementary tools of monetary policy.

It was not until a year after the accord that it had become apparent that the member banks were resorting increasingly to borrowing at the Federal Reserve banks in order to obtain additional reserves for supporting credit expansion. The discount mechanism had fallen more or less into disuse for two decades and could not be reactivated until a flexible open-market policy had been restored. When the monetary authorities deem it desirable to exercise restraint on credit expansion, less reserves are made available to the banks through restrictive open-market operations. In order to obtain additional reserves to meet temporary deficiencies in their legal reserves, the member banks turn to the discount window of the Federal Reserve banks.

An expanding volume of discounts enables the Federal Reserve System to exercise greater control over bank credit expansion. The banks are said to be traditionally reluctant to borrow from the Federal Reserve banks and are also subject to administrative regulations that discourage continuous borrowing. Moreover, replenishing of reserves through the discount window may be made more expensive through the raising of the Federal Reserve discount rate. As a result of these pressures, member banks readjust their loans and investments to meet their obligations to repay promptly. In other words, the discount mechanism acts as a brake in bank credit expansion, and serves as a major supplement to open-market policy as a tool for promoting economic stability.[9]

TABLE 8.—*Installment credit, 1950–52*

[Millions of dollars]

End of month	Total outstanding	Automobile paper [1]	Other consumer goods paper [1]	Repair and modernization loans [2]	Personal loans
1950—January	11,599	4,613	3,671	889	2,426
February	11,669	4,717	3,643	887	2,422
March	11,888	4,868	3,690	872	2,458
April	12,136	5,024	3,760	872	2,480
May	12,534	5,220	3,887	897	2,530
June	13,030	5,504	4,004	922	2,600
July	13,578	5,825	4,159	945	2,649
August	14,045	6,032	4,349	971	2,693
September	14,452	6,191	4,546	996	2,719
October	14,570	6,212	4,611	1,014	2,733
November	14,492	6,133	4,588	1,021	2,750
December	14,703	6,074	4,799	1,016	2,814
1951—January	14,564	5,984	4,727	1,001	2,852
February	14,409	5,910	4,639	988	2,872
March	14,382	5,875	4,591	987	2,929
April	14,321	5,873	4,502	989	2,957
May	14,376	5,932	4,445	1,002	2,997
June	14,437	5,996	4,393	1,003	3,045
July	14,369	5,992	4,289	1,012	3,076
August	14,622	6,108	4,354	1,029	3,131
September	14,766	6,157	4,389	1,045	3,175
October	14,826	6,095	4,478	1,064	3,189
November	14,946	6,048	4,572	1,082	3,244
December	15,294	5,972	4,880	1,085	3,357
1952—January	15,121	5,881	4,776	1,074	3,390
February	15,030	5,848	4,683	1,073	3,426
March	15,032	5,824	4,647	1,071	3,490
April	15,234	5,916	4,667	1,091	3,560
May	15,834	6,249	4,812	1,132	3,641
June	16,588	6,662	5,001	1,174	3,751
July	17,044	6,878	5,133	1,216	3,817
August	17,329	6,946	5,252	1,254	3,877
September	17,669	7,055	5,400	1,297	3,917
October	18,216	7,293	5,626	1,345	3,952
November	18,579	7,504	5,712	1,374	3,989
December	19,403	7,733	6,174	1,385	4,111

[1] Represents all consumer installment credit extended for the purpose of purchasing automobiles and other consumer goods, whether held by retail outlets or financial institutions. Includes credit on purchases by individuals of automobiles or other consumer goods that may be used in part for business.

[2] Represents repair and modernization loans held by financial institutions; holdings of retail outlets are included in other consumer goods paper.

Source: Board of Governors of the Federal Reserve System.

ECONOMIC AND FINANCIAL DEVELOPMENTS IN SECOND HALF OF 1952

Toward mid-1952, there was a quickening in the pace of business activity with accompanying increase in the demand for credit. The index of industrial production rose from 119 in May to 133 in December, except in June and July during the steel strike. The gross

[9] For the most recent Federal Reserve statement on the role of the discount mechanism in monetary policy, see the Forty-fourth Annual Report of the Board of Governors of the Federal Reserve System. 1957, pp. 7–18.

national product rose at an annual rate of $17.3 billion, or 5.1 percent from the second to the final quarter of 1952. Virtually all of the increase arose from the expansion of business inventories and from consumer spending. The rise in consumer spending was facilitated by the rapid expansion of installment credit, especially after the lifting of consumer credit controls. In addition, there was the discontinuance around the middle of the year of direct regulation of real estate credit and of the voluntary credit-restraint program. Defense spending considerably slackened its rate of expansion after the second quarter of the year. The leveling off of defense expenditures in the last half of the year and the substantial growth of production in the civilian sector were accompanied by a decline in wholesale prices and by consumer price stability.

Total loans of all commercial banks increased by $5 billion from June to December 1952 with most of the expansion in consumer and business loans. Total bank investments rose by over $2 billion with practically all of the acquisition in United States Government securities. Despite the greater increase in bank credit in the last half of 1952 as compared to the corresponding period of 1951, the rise in the money supply (adjusted demand deposits and currency in circulation) was about $2 billion less in the second half of 1952 than in the last half of 1951.

FEDERAL RESERVE CREDIT POLICY

With the intensification of the demand for bank credit as business activity accelerated and with a large increase in the demand for funds by the Treasury to finance a Government deficit, there was increasing pressure on bank reserves. In the absence of offsetting open-market operations, the member banks turned increasingly to discounting at the Reserve banks to replenish their reserves. In March 1952 discounts and advances of the Federal Reserve System averaged $314 million; in June the monthly average rose to $585 million; during the next 4 months it was around $1 billion; and in December it reached $1.6 billion.

TABLE 9.—*Open-market transactions in U. S. Government securities,*[1] *July 1, 1951–Sept. 30, 1952*

[Millions of dollars]

Class of security	Total		During periods of refunding [2]		Other than periods of refunding	
	Purchases	Sales	Purchases	Sales	Purchases	Sales
Maturing issues (rights)	3,059		3,059			
Other securities maturing:						
Within 91 days	1,568	2,206	541	372	1,027	1,834
91 days to 14 months	594	2,277	341	1,154	253	1,123
14 months to 5 years	1				1	
5 years to 10 years	3				3	
Over 10 years	23	5	6	3	17	2
Total	5,248	4,488	3,947	1,529	1,301	2,959

[1] Excludes repurchase agreements with dealers and brokers and purchases and sales of special certificates from and to Treasury.
[2] Commitments from date of announcement to closing of books, plus all transactions in new securities on a when-issued basis.

Source: United States Monetary Policy: Recent Thinking and Experience: Hearings, Subcommittee on Economic Stabilization of the Joint Committee on the Economic Report, 83d Cong., 2d sess., 1954, p. 265.

TABLE 10.—*Member bank reserves and related items, 1950–52*

[Averages of daily figures, millions of dollars]

Period	Federal Reserve credit	Gold stock	Currency in circulation	Total reserves	Required reserves
1950—January	18,649	24,420	27,220	16,520	15,585
February	18,310	24,346	27,008	16,146	15,409
March	18,242	24,311	27,043	16,081	15,298
April	18,136	24,247	27,062	15,898	15,204
May	18,005	24,236	27,022	15,941	15,237
June	18,325	24,231	27,026	16,194	15,426
July	18,703	24,192	27,117	16,253	15,507
August	18,877	23,927	27,009	16,273	15,626
September	19,610	23,560	27,154	16,602	15,837
October	20,044	23,366	27,233	16,731	15,889
November	20,159	23,157	27,380	16,742	16,011
December	21,606	22,879	27,806	17,391	16,364
1951—January	21,839	22,523	27,304	18,088	17,263
February	23,286	22,249	27,145	18,907	18,279
March	23,663	21,909	27,171	19,207	18,494
April	23,983	21,806	27,179	19,324	18,491
May	23,686	21,757	27,324	18,892	18,302
June	23,913	21,755	27,548	19,309	18,475
July	24,285	21,757	27,859	19,229	18,473
August	24,264	21,790	27,951	19,174	18,470
September	24,664	21,906	28,213	19,396	18,675
October	24,982	22,104	28,387	19,868	18,952
November	24,785	22,298	28,612	19,794	19,065
December	25,446	22,483	29,139	20,310	19,484
1952—January	24,444	22,824	28,637	20,469	19,536
February	23,826	23,039	28,406	19,995	19,300
March	23,890	23,278	28,437	20,207	19,323
April	23,726	23,293	28,459	19,777	19,127
May	23,704	23,297	28,557	19,767	19,140
June	24,144	23,308	28,843	20,140	19,431
July	24,786	23,348	29,028	20,535	19,926
August	24,824	23,346	29,088	20,306	19,657
September	25,055	23,343	29,343	20,514	19,736
October	25,681	23,340	29,555	20,611	19,963
November	26,172	23,338	29,904	20,744	20,087
December	27,299	23,276	30,494	21,180	20,457

Source: Board of Governors of the Federal Reserve System.

From June to December the required reserves needed to support the increase in bank deposits amounted to $1 billion, and about $1.6 billion of reserve funds were needed to offset the outflow of currency in circulation. The additional reserves were supplied as follows: About $1 billion originated from borrowing from the Federal Reserve, $1.3 billion from outright purchases of Government securities by the Open Market Committee, and about $400 million through the acquisition of securities under repurchase agreements.[10]

The Federal Reserve did not change its preaccord directive "to maintain orderly conditions" in the Government securities market until March 1953 when the present wording "to correct disorderly conditions" was approved. In the interval it underwrote Treasury refunding operations through open-market purchases of the maturing issues for which an exchange was being offered and at times of the new security on a when-issued basis. During the period between July 1, 1951, and September 30, 1952, the Treasury entered the market 9 different times to refund about $49 billion of maturing securities. During these 15 months, purchases of the Open Market Committee amounted to $5.2 billion and were concentrated almost wholly in short-term securities, i. e., issues less than 14 months. About three-fourths of the total purchases were made during periods of refunding and only one-fourth were made between refunding periods. The $3.9 billion of support purchases during refunding

[10] See appendix, p. 78.

TABLE 11.—*Member bank excess reserves, borrowings, and free reserves, 1950–52*

[Averages of daily figures, millions of dollars]

Period	Excess reserves	Borrowings at Federal Reserve banks	Free reserves	Period	Excess reserves	Borrowings at Federal Reserve banks	Free reserves
1950—January	936	35	901	1951—July	756	194	562
February	737	123	614	August	704	292	412
March	783	128	655	September	721	338	383
April	694	101	593	October	915	95	820
May	704	80	624	November	729	340	389
June	767	68	699	December	826	657	169
July	746	123	623	1952—January	933	210	723
August	647	164	483	February	695	365	330
September	765	96	669	March	885	307	578
October	842	67	775	April	650	367	283
November	731	145	586	May	628	563	65
December	1,027	142	885	June	709	579	130
1951—January	825	212	613	July	609	1,077	−468
February	627	330	297	August	649	1,032	−383
March	713	242	471	September	778	683	95
April	833	161	672	October	648	1,048	−400
May	590	438	152	November	657	1,532	−875
June	834	170	664	December	723	1,593	−870

Source: Board of Governors of the Federal Reserve System.

periods were offset at the same time by $1.5 billion of sales of other securities in the portfolios of the Reserve banks. Nearly $3 billion of sales by the Open Market Committee were made between periods of refunding in order to withdraw funds supplied during support operations. However, since total purchases for the 15-month period amounted to $5.2 billion and total sales were nearly $4.5 billion, this meant that offsetting sales fell short of purchases by $700 million. This additional Federal Reserve credit occurred during the sizable August and September 1952 Treasury refunding operations when a large part of the substantial increase in open-market purchases was not offset by sales transactions.

The decision not to withdraw funds supplied in support of the August and September 1952 refundings reflected the tightening situation in the money market, a condition that was becoming more apparent since the spring of 1952. The increasing pressure on member bank reserves is evident from an examination of table 11 showing the member bank reserve balances and the amount of rediscounting at the Federal Reserve banks. Particularly significant for indicating stringency of credit conditions is the difference between excess reserves (i. e., total reserves less legal required reserves) and member bank borrowings at the Federal Reserve banks. This difference is known as free reserves.

There was a downward trend in free reserves since the spring of 1952, becoming negative in the latter half of the year. In November and December free reserves were minus $900 million.

Tightness in the money market was reflected in the rise in the yields of securities, particularly the Treasury bill rate. The monthly average of Treasury 3-month bills rose from 1.57 in February 1952 to 2.12 in December. The last half of the year the bill rate was above the 1¾ percent discount rate of the Federal Reserve. When the bill rate is above the discount rate, there is some encouragement for banks to borrow from the Federal Reserve banks rather than to dispose of bills, but it was not until January 1953 that the Federal

Reserve banks attempted to bring the discount rate more nearly in line with short-term market rates by raising the discount rate to 2 percent. Another factor in the growth of member bank borrowing was the excess-profits tax which made it profitable for potentially affected banks to borrow during this period. As table 11 shows, total member bank borrowing and net borrowed reserves grew rapidly. They would have grown even more rapidly, however, had it not been for purchases of the Open Market Committee.

TABLE 12.—*Annual rate of turnover of demand deposits, 1950–52* [1]

[Ratio of debits to deposits]

Period	New York City	6 other centers [2]	338 other reporting centers	Period	New York City	6 other centers [2]	338 other reporting centers
1950—January	29.0	20.9	16.3	1951—July	31.1	23.3	18.0
February	29.0	20.9	15.8	August	27.6	22.1	17.3
March	30.1	23.5	16.0	September	30.6	23.6	18.3
April	28.4	22.0	15.7	October	31.2	23.1	18.4
May	30.0	21.7	16.2	November	32.1	24.4	19.6
June	31.6	23.2	17.0	December	35.9	24.3	19.0
July	29.0	21.5	17.1	1952—January	31.2	23.0	18.3
August	34.5	22.2	17.1	February	32.3	23.4	18.5
September	32.8	23.5	18.4	March	33.6	25.7	18.2
October	30.6	23.0	18.3	April	34.0	24.6	17.8
November	32.3	24.0	19.1	May	32.8	22.8	17.9
December	36.1	25.2	19.2	June	37.4	24.9	18.8
1951—January	32.5	24.7	19.0	July	34.4	24.0	18.1
February	30.1	23.5	18.3	August	29.6	20.8	17.0
March	35.1	26.4	18.5	September	35.4	24.3	18.9
April	32.5	25.6	18.5	October	36.4	25.0	18.7
May	31.0	24.2	18.3	November	34.1	24.1	19.3
June	33.7	24.0	18.4	December	41.8	26.9	19.8

[1] Does not include interbank and U. S. Government deposits and is given without seasonal adjustment.
[2] Boston, Philadelphia, Chicago, Detroit, San Francisco, Los Angeles.

Source: Board of Governors of the Federal Reserve System.

Chapter II. Federal Reserve Policies in 1953–54

The first half of 1953 is an especially interesting period to the student of monetary policy. It posed a series of issues to the Federal Reserve Board and the Open Market Committee which have been discussed ever since not only in the academic literature but by the Congress itself, particularly at committee hearings where monetary and fiscal problems affecting economic stability are under consideration. On some of these questions there have been sharp differences of opinion within the Federal Reserve System, in the Congress, and among economists. Some of the issues are quite technical and on the surface appear to be concerned only with the operating techniques of what has come to be the most important tool of monetary policy, namely, open-market operations. But they cannot be readily dismissed on the grounds that the issues involve only considerations of the technical operations of the System's open-market account. They raise important questions of credit policy which have a significant bearing on the objective of promoting the stability and growth of the economy through the use of the powers of the Federal Reserve System.

The issues referred to in the preceding paragraph all came to the fore at the March 1953 meeting of the Open Market Committee and are reported in the record of its policy actions in the Federal Reserve Board's Annual Report for 1953. The first of the policy decisions was concerned with the longstanding directive to the Executive Committee to continue, as it had done since August 1951, to operate "with a view to exercising restraint upon inflationary developments." The second, involving a change from previous directives, provided that the Executive Committee should arrange for transactions in the System open-market account with a view "to correcting a disorderly situation in the Government securities market," rather than as previously, "to maintaining orderly conditions in the Government securities market." The third action instructed the Executive Committee that "operations for the System account should be confined to the short end of the market (not including correction of disorderly markets)." In practice, this meant confining operations to Treasury bills. The System account was also to refrain from support purchases in the market during periods of Treasury refinancing.

APPRAISALS OF THE BUSINESS SITUATION, FIRST HALF OF 1953

Let us first consider the early March directive which instructed the Executive Committee to continue to operate "with a view to exercising restraint upon inflationary developments." The assumption that the economy was likely to be dominated by inflationary developments explains in large measure the controversies about Federal Reserve policy and Treasury debt management policy that flared up in the Congress and in the financial and business community during the first half of 1953. Particularly important for the purposes of this

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report is that the controversies bring to the fore certain limitations in the use of the tools of monetary policy (and fiscal and debt management policy) for promoting economic stability. As we shall see in the next chapter, these limitations are not only apparent in a review of the first half of 1953; they become even more apparent in the review of later Federal Reserve actions. The limitations referred to relate to the difficulties involved in appraisals of changes in the business situation, currently and for the near future.

As the Open Market Committee saw it, economic activity which had been expanding at a rapid rate in the second half of 1952 was continuing to expand further in the early months of 1953. Industrial production, the gross national product, and business inventories were increasing, and unemployment was exceptionally low. At the same time the demand for capital and credit continued strong, especially mortgage and consumer credit, despite the raising of the discount rate from 1¾ percent to 2 percent around the middle of January.

There were some observers who did not anticipate continuation of inflationary pressures. Typical of those who were critical of the Open Market Committee's concern with further inflationary developments was Mr. Marriner Eccles, former Chairman of the Federal Reserve Board, who argued that the signs pointed rather to deflationary developments. The wholesale and consumer price levels had stabilized. It was also pointed out that the production of automobiles and other consumer durable goods and the construction of housing were reaching a point of saturation in relation to demand, and that Government expenditures were scheduled to reach a peak and start declining during the year.[1] These appraisals of current developments were publicly expressed at the same time that spokesmen for the Federal Reserve and the Treasury were publicly stressing the predominance of inflationary pressures calling for monetary and debt management policies of an anti-inflationary character.

TABLE 13.—*Indexes of industrial production, wholesale and consumer prices, 1953–54*

[1947–49=100]

Month	Industrial production [1]	Wholesale prices	Consumer prices	Month	Industrial production [1]	Wholesale prices	Consumer prices
1953—January	134	109.9	113.9	1954—January	125	110.9	115.2
February	134	109.6	113.4	February	125	110.5	115.0
March	135	110.0	113.6	March	123	110.5	114.8
April	136	109.4	113.7	April	123	111.0	114.6
May	137	109.8	114.0	May	125	110.9	115.0
June	136	109.5	114.5	June	124	110.0	115.1
July	137	110.9	114.7	July	123	110.4	115.2
August	136	110.6	115.0	August	123	110.5	115.0
September	133	111.0	115.2	September	124	110.0	114.7
October	132	110.2	115.4	October	126	109.7	114.5
November	129	109.8	115.0	November	128	110.0	114.6
December	126	110.1	114.9	December	130	109.5	114.3

[1] Seasonally adjusted.

Source: Board of Governors of the Federal Reserve System and U. S. Department of Labor.

[1] Washington Post, April 15, 1953.

To be sure, at any given time, analysts of business conditions differ in their appraisals of current economic developments. In view of the fact that more or less the same statistical and other pertinent data are available to competent and trained observers, such differences must be largely interpretative and analytical in character. Since even in periods of general high and expanding levels of activity there are sectors of the economy that are contracting rather than expanding, there are bound to be differences in judgment as to the relative influence of the diverse movements that are taking place. Unfortunately, psychological and other biases enter into these judgments, especially during periods of prosperity, which result in minimizing the unfavorable influences that appear on the business horizon and the neglect of which may result in faulty policy decisions. Fortunately, however, one of the virtues of monetary policy, as compared to fiscal and debt management policy, is its greater flexibility. The monetary authorities are generally in a better position to minimize errors of diagnosis by more speedily steering a different course to meet changing conditions. As we shall see, this was the case in 1953; it may have been less so in 1957.

Let us examine some of the statistical series which measure the behavior of the economy during this period. The index of industrial production, which rose from 115 in July 1952 to 133 in November and December, climbed to 137 in May 1953. This would appear to indicate that the rate of expansion in production was slackening in the earlier part of 1953. The gross national product, which increased at an annual rate of $11.6 billion between the third and fourth quarters of 1952, rose by $5.9 billion in the first quarter of 1953, and by an annual rate of $4.3 billion in the second quarter. To some observers at the time, the slackening in the rate of economic activity, as indicated by such broad-gaged measures as the index of industrial production and the gross national product, meant that the economy was approaching the peak in the expansion phase of the business cycle and would soon turn down. To others, especially the monetary authorities, whose daily activities in the area of credit indicated continuing strong pressures for additional funds, the slackening in the rate of economic expansion—even if it could be so gaged at the time—might only be temporary, to be followed by a further upward surge of activity in the months ahead. Officials of the Federal Reserve have pointed out that business inventories were rising at the time, and they interpreted this rise as an indication of the intensification of inflationary pressures. However, a rise in inventories could also signify that production and sales were growing out of balance, a condition that could culminate in readjustments of a deflationary character. Toward midyear, when inflation was still the dominant theme, it was becoming more apparent that such readjustment was in process.

When one turns from general measures of business activity and examines the behavior of specific areas, there were a number of signs early in 1953 which indicated impending change in a downward direction. It is sufficient to cite only a few of such indicators. Industrial stock prices, which in the past have manifested a definite tendency to lead at cyclical turning points of business activity, moved downward during each of the first 6 months of 1953. Orders for manufacturers' durable goods and the average length of the manufacturing workweek started to decline in the spring. The rise in retail sales

was halted in February, while business inventories continued to expand through the summer. It is precisely at the time when aggregate measures of business conditions indicate increasing buoyancy in the economy at more or less peak levels that there is intensification of concern about inflationary pressures. It is at such times also that there is a tendency to ignore imbalances that have been building up in certain sectors for a number of months but which only become visible later on in the general measures of business activity. With retail sales sluggish since the early months of 1953, while inventories were piling up, a downward adjustment in the economy rather than a further upward push was the more likely prospect.

MONEY AND BANK CREDIT, FIRST HALF OF 1953

Turning from the industrial sector, where production was at peak levels while key individual sectors were manifesting signs of weakness, to the financial sector, let us examine briefly the changes in the money supply and some of the major influences affecting bank reserves.

Demand deposits and currency, which usually move downward during the first half of the year and rise substantially in the second half, declined more sharply in the first 6 months of 1953 than in the corresponding periods of 1950–52. The relatively greater decline in the money supply largely reflected a shrinkage in bank holdings of Government securities in the amount of $4.2 billion during the first half of 1953. The commercial banks not only sold Government securities to meet the large demands for credit; they also continued to rely heavily on borrowing from the Federal Reserve banks. In January their discounts and advances were nearly $1.4 billion and in April they were close to $1.2 billion.

There is little doubt that the reserve positions of the banks were under pressure. This pressure was exerted by foreign gold withdrawals starting in December and by restrictive Federal Reserve open-market operations. The latter may be seen from table 14 showing open-market transactions for 1953. In the first part of the year there were no outright purchases of Government securities and over $200 million of sales. There was also substantial reselling of securities which had been purchased in December under repurchase agreements with dealers in short-term Government securities. As a result of these operations, there was a net reduction in Federal Reserve holdings of Government securities and to that extent an absorption of member bank reserves. Free reserves, i. e., excess member bank reserves less borrowings by member banks, were minus at least $600 million in each of the first 4 months of 1953.

The pressures on credit resulted in a general firming of interest rates to mid-April and a sharp advance to early June. Between January and June, the monthly averages of Treasury bill rates rose from 2.04 percent to 2.23 percent, prime commercial paper from 2.31 percent to 2.75 percent, and long-term Governments from 2¾ to 3¼ percent.

TABLE 14.—*Gross transactions in Government securities by the Federal Open Market Committee, January–December 1953*

[In millions of dollars]

	Net change in Federal Reserve holdings	Market transactions (gross)						Special certificates purchased directly from Treasury (largest amount outstanding in month)	Exchange of maturing certificates, notes, and bonds
		Total		Outright transactions [1]		Repurchase agreements with dealers			
		Purchases	Sales	Purchases	Sales	Purchases	Sales		
January	−753.4	478.2	1,231.6		145.7	478.2	1,085.9		350.1
February	−68.3	242.9	311.2		35.3	242.9	275.9		3,886.9
March	−69.2	119.0	188.2		46.2	119.0	142.0	333.0	270.5
April	+74.0	551.5	477.5	75.5	75.5	476.0	402.0		
May	+366.3	780.4	414.1	225.0		555.4	414.1		281.3
June	+499.8	883.8	384.0	687.1		196.7	384.0	1,172.0	1,152.8
July	+217.5	355.5	138.0	245.5		110.0	138.0		503.0
August	+99.5	244.4	144.9	25.0		219.4	144.9		710.9
September	+171.5	817.9	646.4	263.7	17.7	554.2	628.7		1,398.2
October	+113.0	170.0	57.0	113.0		57.0	57.0		702.7
November	[2]−252.5	849.5	1,102.0	165.0	[2] 520.0	684.5	582.0		591.0
December	+820.4	2,801.6	1,981.3	375.0	50.0	2,426.6	1,931.2		7,978.4
Total	+1,218.6	8,294.7	7,076.1	2,174.8	890.4	6,119.9	6,185.7	1,505.0	17,825.8

[1] Includes runoff of Treasury bills at maturity.
[2] Includes 2⅛-percent notes of December 1953, redeemed with gold certificates.

Source: Hearings on January 1954 Economic Report of the President, Joint Committee on the Economic Report, 83d Cong., 2d sess., February 1954, p. 133.

Around mid-February the Federal Reserve Board reduced margin requirements on stock market credit from 75 to 50 percent. In explaining its action the Board stated: [2]

> The margin requirements had been increased from 50 to 75 percent in January 1951 as a preventive measure and as a supplement to the steps previously taken in the credit and monetary area to lessen inflationary pressures. By February 1953 inflationary pressures had moderated and, with the margin requirements fixed at 75 percent, there had been no substantial increase in the total amount of credit in use in the stock market. Accordingly, the Board concluded that margin requirements of 50 percent would be adequate to prevent the excessive use of credit for the purchasing and carrying of securities and that a reduction to that level would be in harmony with the System's overall credit and monetary policy under current conditions.

To be sure, inflationary pressures in early 1953 were certainly not as strong as in early 1951, but they were apparently regarded as sufficiently strong for the System to raise the discount rate in January 1953 and to restrict bank reserves through open-market operations. Consequently, critics pointed out at the time that the Board's action in lowering margin requirements was inconsistent with its concern about "inflationary developments" and with its restrictive general monetary policy.

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[2] Fortieth Annual Report of the Board of Governors of the Federal Reserve System, 1953, p. 83.

TABLE 15.—*Bond yields and interest rates, 1953–54*

[Percent per annum]

Period	U. S. Government securities				Corporate bonds (Moody's)		Common stock yields, 200 stocks, (Moody's)	High-grade municipal bonds (Standard & Poor's)	Average rate on short-term bank loans to business, selected cities	Prime commercial paper, 4 to 6 months	Federal Reserve bank discount rate
	3-month Treasury bills	9-to-12-month issues [1]	Taxable bonds		Aaa	Baa					
			10 to 20 years [2]	20 years and over [3]							
1953—January	2.042	1.97	2.80	----------	3.02	3.51	5.15	2.47	----------	2.31	[4] 2.00
February	2.018	1.97	2.83	----------	3.07	3.53	5.22	2.54	----------	2.31	2.00
March	2.082	2.04	2.89	----------	3.12	3.57	5.34	2.61	3.54	2.36	2.00
April	2.177	2.27	2.97	----------	3.23	3.65	5.49	2.63	----------	2.44	2.00
May	2.200	2.41	3.09	3.26	3.34	3.78	5.51	2.73	----------	2.67	2.00
June	2.231	2.46	3.09	3.29	3.40	3.86	5.58	2.99	3.73	2.75	2.00
July	2.101	2.36	2.99	3.25	3.28	3.86	5.46	2.99	----------	2.75	2.00
August	2.088	2.33	3.00	3.22	3.24	3.85	5.75	2.88	----------	2.75	2.00
September	1.876	2.17	2.97	3.19	3.29	3.88	5.73	2.88	3.74	2.74	2.00
October	1.402	1.72	2.83	3.06	3.16	3.82	5.59	2.72	----------	2.55	2.00
November	1.427	1.53	2.85	3.04	3.11	3.76	5.53	2.62	----------	2.31	2.00
December	1.630	1.61	2.79	2.96	3.13	3.74	5.55	2.59	3.76	2.25	2.00
1954—January	1.214	1.33	2.67	2.90	3.06	3.71	5.33	2.50	----------	2.11	2.00
February	.984	1.01	2.58	2.85	2.95	3.61	5.32	2.39	----------	2.00	[5] 1.75
March	1.053	1.02	2.50	2.73	2.86	3.51	5.14	2.38	3.72	2.00	1.75
April	1.011	.90	2.45	2.70	2.85	3.47	4.94	2.47	----------	1.76	[6] 1.50
May	.782	.76	2.52	2.72	2.88	3.47	4.88	2.49	----------	1.58	1.50
June	.650	.76	2.53	2.70	2.90	3.49	4.82	2.48	3.60	1.56	1.50
July	.710	.65	2.45	2.62	2.89	3.50	4.61	2.31	----------	1.45	1.50
August	.892	.64	2.46	2.60	2.87	3.49	4.75	2.23	----------	1.33	1.50
September	1.007	.89	2.50	2.64	2.89	3.47	4.46	2.29	3.56	1.31	1.50
October	.987	1.03	2.52	2.65	2.87	3.46	4.57	2.32	----------	1.31	1.50
November	.948	.94	2.55	2.68	2.89	3.45	4.39	2.29	----------	1.31	1.50
December	1.174	1.10	2.57	2.68	2.90	3.45	4.20	2.33	3.55	1.31	1.50

[1] Includes certificates of indebtedness and selected note and bond issues.
[2] 2½ percent bonds, 15 years and over prior to April 1952 and 12 years and over beginning April 1952.
[3] 3¼ percent bonds of 1978–83, 1st issued May 1, 1953.
[4] Effective Jan. 16, 1953.
[5] Effective Feb. 5, 1954.
[6] Effective Apr. 16, 1954.

Sources: Board of Governors of Federal Reserve System, Treasury Department, Moody's Investor Service, and Standard and Poor's Corp.

THE OBJECTIVE OF A FREE MARKET

One cannot fully understand monetary and debt management policy as well as conditions in the money market during the first half of 1953 without consideration of the March directives of the Open Market Committee other than that of "exercising restraint on inflationary developments." Since these directives, mentioned at the beginning of this chapter, have also played an important role in Federal Reserve policy ever since, it is essential that we examine them more closely.[3]

The change in the directive to the Executive Committee from "maintenance of orderly conditions" to that of "correction of disorderly conditions in the Government securities market" was designed to make more explicit the commitment of Federal Reserve policy to a philosophy of a "free securities market." It was intended to reassure dealers and professional buyers and sellers of Government securities that the forces of supply and demand would determine the prices and yields of Government securities and that in such a market they would not be subject to the hazards of unpredictable intervention by the Open Market Committee. The Federal Reserve would confine its operations to releasing and absorbing reserve funds in order to effectuate its general credit policies. Only in extreme circumstances would the Open Market Committee step in to correct a market that was clearly disorderly.

To reinforce the goal of a "free market" there were the additional directives: (1) Open-market operations would be confined to the short end of the market; (2) support of the market during periods of Treasury refinancing would be discontinued; (3) the policy of the Committee was not to support any pattern of prices and yields in the market.

The view that yields on Government securities should be determined by a free money market was vigorously expounded in speeches in the spring of 1953 by the Chairman of the Board of Governors and by the Secretary of the Treasury. This view was regarded with much less enthusiasm by a number of critics, among whom were distinguished economists.[4] They pointed out that the Federal Reserve System came into existence precisely because the country had learned from the bitter experience of the past that it was dangerous to the stability

[3] These directives which were adopted at the March meeting of the Open Market Committee are based on recommendations of an ad hoc subcommittee appointed in 1951 to study methods of improving the effectiveness of open market operations. The full text of the report of the ad hoc subcommittee on the Government securities market, which was submitted to the Open Market Committee in November 1952, was first made public 2 years later in United States Monetary Policy: Recent Thinking and Experience: Hearings before the Subcommittee on Economic Stabilization, Joint Committee on the Economic Report, 83d Cong., 2d sess., 1954, pp. 257–307.

[4] Among the critics of the "free market philosophy" was Prof. Lester V. Chandler of Princeton University:

"* * * High officials in the Treasury Department have at times suggested that interest rates should be determined by the market forces of demand and supply, and the Chairman of the Board of Governors made a memorable speech describing the transition to 'free markets,' which was to include a 'free money market.' This was, in my opinion, an unfortunate choice of words. * * * But to allow the total supply of money and loans, and the price of loans, to be determined by private demand and private supply would negate the very idea of central banking. Central banks exist because we are not willing to allow the total supply of money and credit, and the cost of credit, to be determined by the unregulated forces of private supply and demand. The basic function of a central bank is to regulate the total supply of money and credit and the terms on which they are made available. It should be clear that the Federal Reserve can make its maximum contribution to economic stability and growth only by recognizing its continuous responsibility for money market conditions, and by taking whatever positive actions that may appear conducive to the attainment of its objectives. * * * A successful policy of economic stabilization cannot be a passive policy * * * (United States Monetary Policy: Recent Thinking and Experience, cited in footnote 3; pp. 45–46).

For this and the next section see Alvin H. Hansen, The American Economy, McGraw-Hill, 1957, ch. 4. Also Paul A. Samuelson, Recent American Monetary Controversy, The Three Banks Review, March 1956; also Deane Carson, Recent Open Market Committee Policy and Techniques, Quarterly Journal of Economics, August 1955; and C. R. Whittlesey, Monetary Policy and Economic Change, Review of Economics and Statistics, February 1957.

of the economy to permit the unregulated forces of supply and demand to determine the total volume of credit and its cost. Strict adherence to the "free-market" philosophy, instead of making open-market operations more effective, represented a degree of passivity on the part of the Federal Reserve which was likely to weaken credit policy as a tool for stabilization. It was incompatible with economic developments in recent decades in which so high a proportion of total indebtedness had come to be represented by Government debt. According to the critics, there are periods when it is highly desirable in the interests of promoting economic stability and growth that the monetary authorities take an active role in influencing the course of interest rates. This may be accomplished at times through regulating the volume of bank reserves; at other times it may be necessary to operate directly in the long-term sector of the Government security market.

According to its proponents, the free market promotes "market depth, breadth, and resiliency." In such a market dealers are active in buying and selling not only as brokers for institutional investors but also for their own account. In operating in the latter capacity, they rely heavily on the use of borrowed funds. To such dealers a very small change in bond prices and yields may make all the difference between a profitable and an unprofitable transaction. They may be prepared to take risks in a free market. But when it is subject to uncertainties originating from Open Market Committee intervention, dealers are reluctant to take trading positions that involve sizable amounts of borrowed funds.

THE POLICY OF BILLS-ONLY

If the free market is to provide depth, breadth, and resiliency, then, according to the Committee, it is desirable that open-market operations be confined to short-term securities, and there should be no intervention in the intermediate and long-term sectors. The Government securities market has "depth" when there are orders to buy and sell above and below the current market price; it has "breadth" when orders are large in volume and come from widely divergent investor groups; it has "resiliency" when there are small fluctuations in price due to speedy investor reactions to small changes in market conditions. These conditions are more nearly fulfilled in the market for Treasury bills and when dealers are assured that the Open Market Committee will limit its operations to this sector. When the Committee enters the short end of the market with a view either to increasing or decreasing bank reserves, it has relatively the smallest effect on price changes and on the asset value of investor portfolios. On the other hand, if it were to operate directly in the long-term bond market, dealers would find the risks of sharp fluctuations in bond prices much too great.

Mr. Allan Sproul, President of the Federal Reserve Bank of New York and Vice Chairman of the Open Market Committee, agreed with his colleagues that the Committee should avoid continuously intervening in the market to influence the structure of interest rates and thus permit the free market to govern. But he strongly opposed adoption of the "bills only" approach to open-market operations. While voting for the March 4 directive to substitute for the "maintenance of orderly conditions" the clause "correction of disorderly

situations in the market," he thought the emphasis should be on the "avoidance of disorderly situations rather than their correction after they happened." [5]

> * * * One of the virtues of credit control is supposed to be its ability to take prompt action to head off financial disturbances which might otherwise have harmful repercussions throughout the economy. If open-market operations in longer term Government securities can be used to this end, I would use them rather than wait until a disorderly situation or a crisis has developed, and only then depart from operations solely in Treasury bills * * *.[6]

Mr. Sproul contended that to confine open-market operations to the short end of the market was to place monetary management in a straitjacket; that there were circumstances when credit policy would be more effective if it operated directly in the long-term sector. The Federal Reserve Bank of New York questioned the view that it is fear of Federal Reserve intervention that produces uncertainty and therefore thin markets.

> * * * Clearly it is the appraisals of the outlook for interest rates and security prices by dealers and investors, much more than any fear (or hope) of intervention by the System in the market for particular securities, that determine the "depth, breadth, and resiliency" of the market at any given time. Fear of adverse trends, or uncertainty as to what the trend is likely to be, is the predominant reason for thin markets, rather than apprehensions concerning System intervention in particular sectors to limit price movements * * *.[7]

Mr. Sproul questioned the majority view that operations in very short-term securities are transmitted speedily to the longer sectors of the market through arbitrage transactions by dealers. For example, in a period of business recession when monetary authorities pursue a policy of credit ease by increasing bank reserves through purchase of Treasury bills, their yields may go down substantially, while long-term rates may not be lowered much or soon enough to stimulate business investment. If there were direct intervention in the longer sector of the market, Federal Reserve credit policy would be more effective in achieving its objective of promoting economic stability.

DEBT MANAGEMENT POLICY: THE TREASURY'S 3¼S

At the same time that the Federal Reserve was stressing the importance of the free market with noninterference by the System, the Treasury was even more emphatically expounding the virtues of a free market for Government securities and of a debt management policy that aimed at refunding the debt into longer maturities. It was maintained that stretching out the debt through issuance of long-term bonds was essential to curb inflationary pressures. Moreover, borrowing from nonbank investors rather than from commercial banks did not result in an increase in the money supply during a period when it was considered important to reduce spending.

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[5] United States Monetary Policy: Recent Thinking and Experience, cited in footnote 3; p. 225.
[6] Ibid, p. 225.
[7] Ibid., p. 310.

Early in April 1953, the Treasury announced the offering of $1 billion of 30-year bonds at 3¼ percent. Although the issue was heavily oversubscribed, these bonds quickly declined below par even before the May 1 issue date. About the same time banks increased their prime commercial loan rate from 3 percent to 3¼ percent. The yields on municipal, State, and corporate bonds also advanced sharply. In early May, maximum interest rates on FHA-insured and VA-guaranteed mortgages were increased from 4¼ and 4 percent respectively, to 4½ percent.

The 3¼ percent bond issue brought forth considerable criticism in the Congress and in the editorial pages of influential financial papers and weeklies. Criticism was directed not only at the Treasury for its decision to launch its program of stretching out the debt at this time and for the excessive rate of interest fixed for the issue, but it was also directed at the Federal Reserve for continuing its policy of monetary restraint. The tight monetary policy was being overdone with the consequence that prices of seasoned Government and industrial bonds were slumping badly and interest rates were climbing rapidly along a wide front. Moreover, it had become apparent that the Treasury would have to borrow in much greater amounts because of the sizable budget deficit that was expected in the latter half of the year. Tension in the money market in May increased further when the Treasury offered 1-year 2⅝-percent certificates in exchange for $5 billion 1⅞-percent maturing certificates and for $700 million of 2-percent bonds. Greater apprehension on the part of lenders as to the future of interest rates and fear that the Federal Reserve would continue its restrictive credit policy increased investor reluctance to commit funds at existing rates. On June 1–2, the Government securities market became demoralized, as evidenced by the fact that there were practically no bids for United States Treasury securities. Only a few days earlier it had also become clear that reception of the new 2⅝s was disappointing.

THE MIDYEAR SHIFT IN FEDERAL RESERVE POLICY

In the second week of May, the System began to take some cognizance of the growing tensions in the money market by supplying reserves to member banks through a moderate amount of open-market purchases. But the release of Federal Reserve credit in May was inadequate to meet a situation in which there were large private demands for credit, in part the result of the fear that funds would be difficult to obtain later on and would command higher interest rates, and increasing demands for funds by the Government. With the demoralization of the bond market and the tensions in the financial markets generally at the beginning of June, the Federal Reserve began to move much more vigorously to ease the financial situation. It greatly stepped up purchases of Treasury bills. Between early May and early July the System increased its holdings of United States Government securities by $1.2 billion. And even more aggressive across-the-board action was taken when the Federal Reserve Board announced on June 24 a reduction of reserve requirements on demand deposits from 24 to 22 percent in central Reserve city banks, from 20 to 19 percent in Reserve city banks, and from 14 to 13 percent in country banks. The release of reserves in May and June through open-market

operations was accompanied by a sharp decline in borrowings at Federal Reserve banks, so that the amount of discounting in June was down to one-third the average for the first 4 months of the year. Free reserves which were minus at least $600 million in these months became plus $364 million in June.

TABLE 16.—*Gross national product seasonally adjusted at annual rates, 1953–54*

[Billions of dollars]

	1953				1954			
	I	II	III	IV	I	II	III	IV
Gross national product	364.5	368.8	367.1	361.0	360.0	358.9	362.0	370.8
Personal consumption expenditures	230.9	233.3	234.1	232.3	233.7	236.5	238.7	243.2
Durable goods	33.2	33.4	33.6	31.2	31.2	32.2	32.3	33.9
Nondurable goods	118.1	118.6	117.8	117.4	117.9	118.8	119.6	121.0
Services	79.6	81.2	82.8	83.7	84.6	85.5	86.9	88.3
Gross private domestic investment	52.0	52.9	51.1	45.2	46.6	47.2	48.8	52.3
New construction	26.9	27.8	27.7	27.9	27.8	28.9	30.2	31.6
Residential nonfarm	13.7	14.0	13.8	13.7	13.7	14.7	15.8	17.0
Other	13.2	13.8	14.0	14.2	14.1	14.2	14.4	14.6
Producers' durable equipment	22.5	22.0	22.6	21.9	21.4	20.9	20.7	19.9
Change in business inventories: total	2.5	3.1	.7	−4.6	−2.6	−2.7	−2.1	.8
Nonfarm only	3.0	4.0	1.5	−4.3	−2.8	−3.2	−2.8	.2
Net foreign investment	−2.1	−2.6	−2.0	−1.4	−1.0	−.4	−.9	.7
Government purchases of goods and services	83.7	85.2	83.8	84.9	80.8	75.5	75.5	74.6
Federal	59.2	60.9	58.9	59.2	54.2	48.3	47.3	45.9
National security	52.1	53.0	51.3	49.8	46.6	43.1	41.9	40.6
Other	7.6	8.3	8.0	9.7	8.0	5.6	5.8	5.6
Less Government sales	.5	.4	.4	.3	.4	.4	.4	.3
State and local	24.4	24.3	24.9	25.7	26.5	27.3	28.2	28.7

Source: Department of Commerce.

The May shift in Federal Reserve policy from credit restraint to credit ease was not due primarily, as is sometimes asserted, to the expectation by the monetary authorities that the economy was about to slip into a business recession which it was deemed desirable to counteract. The measures designed to ease credit were initially undertaken rather in response to a critical situation that had been permitted to develop in the financial markets—a situation that was frequently described at the time as reaching nearly panic proportions. As a result of the Federal Reserve moving vigorously in June to reverse the course of monetary policy, the rise of interest rates came more or less to an abrupt halt and the strained condition in the credit markets quickly eased.

THE 1953–54 BUSINESS RECESSION

Apart from the question as to whether the extensive open-market purchases and the lowering of reserve requirements in June were the result of Federal Reserve prevision of a change in business conditions, there can be little doubt that these actions created a favorable financial environment for meeting the problems of economic readjustment in the period immediately ahead. For it was only a matter of weeks after the system moved aggressively to ease credit conditions that the general level of business activity began to move downward. The index of industrial production dropped from a peak of 137 in July to 123 in March 1954 and more or less remained at this level through

August. The gross national product declined from an annual rate of $368.8 billion in the second quarter of 1953 to $360 billion in the first quarter of 1954.

TABLE 17.—*Disposition of disposable personal income, 1953-54*

[Seasonally adjusted quarterly totals at annual rates]

[Billions of dollars]

Period	Disposable personal income	Personal consumption expenditures	Personal saving	Saving as percent of disposable personal income
1953—1st quarter	250.0	230.9	19.0	7.6
2d quarter	252.8	233.3	19.6	7.8
3d quarter	253.8	234.1	19.7	7.8
4th quarter	253.8	232.3	21.6	8.5
1954—1st quarter	254.6	233.7	21.0	8.2
2d quarter	254.8	236.5	18.3	7.1
3d quarter	256.8	238.7	18.0	7.0
4th quarter	260.9	243.2	17.7	6.8

Source: Department of Commerce.

How much of an influence did the restrictive monetary policy and the tight money market have in bringing on the recession? There is little doubt that in the spring months builders found it more difficult to secure funds for construction, and it was also the case that the peak of housing starts was reached in April and moved downward during the remainder of the year. There was also some evidence of postponement of other capital ventures because of unfavorable credit conditions. To some extent, then, the tight money policy was an influence contributing to a slackening in economic activity but its effect in no way compares with the impact of two other factors that were of major importance in the business recession. The first, and initial factor, was business inventory adjustments, and the second was the cutback in defense contracts.

Businessmen were adding to their inventories at an annual rate of $3.1 billion in the second quarter of 1953, and at the very moderate rate of $0.7 billion in the third quarter; by the fourth quarter of the year they were reducing their inventories at a rate of $4.6 billion. National security expenditures, which were at an annual rate of $53 billion in the second quarter—the peak of such expenditures since the beginning of the Korean war—dropped to $49.8 billion in the fourth quarter and moved downward throughout 1954 to a rate of $40.6 billion in the last quarter of the year. The tight money policy can hardly be said to have contributed to the reduction either of investment in inventories or of defense expenditures. The liquidation of inventories occurred because production and sales had fallen out of balance, especially in the consumer durable goods sector, and because of curtailment of the defense program.

TABLE 18.—*Installment credit, 1953–54*

[Millions of dollars]

End of month	Total outstanding	Automobile paper [1]	Other consumer goods paper [1]	Repair and modernization loans [2]	Personal loans
1953—January	19,586	7,899	6,145	1,380	4,162
February	19,720	8,093	6,070	1,381	4,176
March	20,150	8,397	6,100	1,392	4,261
April	20,551	8,693	6,124	1,412	4,322
May	21,016	8,996	6,200	1,441	7,629
June	21,467	9,241	6,287	1,472	7,565
July	21,887	9,514	6,337	1,500	7,371
August	22,146	9,677	6,369	1,524	7,402
September	22,317	9,772	6,379	1,557	7,466
October	22,503	9,875	6,422	1,585	7,588
November	22,654	9,898	6,485	1,609	7,618
December	23,005	9,835	6,779	1,610	8,238
1954—January	22,638	9,650	6,622	1,595	7,688
February	22,365	9,497	6,490	1,581	7,283
March	22,160	9,403	6,331	1,571	7,152
April	22,207	9,416	6,296	1,575	7,402
May	22,268	9,459	6,256	1,594	7,633
June	22,501	9,604	6,261	1,596	7,699
July	22,658	9,722	6,234	1,604	7,634
August	22,740	9,769	6,214	1,615	7,587
September	22,803	9,781	6,218	1,622	7,676
October	22,881	9,768	6,280	1,628	7,834
November	22,983	9,720	6,377	1,626	8,000
December	23,568	9,809	6,751	1,616	8,724

[1] Represents all consumer installment credit extended for the purpose of purchasing automobiles and other consumer goods, whether held by retail outlets or financial institutions. Includes credit on purchases by individuals of automobiles or other consumer goods that may be used in part for business.

[2] Represents repair and modernization loans held by financial institutions; holdings of retail outlets are included in other consumer goods paper.

Source: Board of Governors of the Federal Reserve System.

From the second to the fourth quarter of 1953, consumer expenditures for durable goods declined by $2.2 billion and for nondurables $1.2 billion, while expenditures for services rose by $2.5 billion. During the same period, personal saving as a percent of disposable

TABLE 19.—*Member bank reserves and related items, 1953–54*

[Averages of daily figures, millions of dollars]

Period	Federal reserve credit	Gold stock	Currency in circulation	Total reserves	Required reserves
1953—January	26,586	23,101	29,920	20,958	20,251
February	26,080	22,797	29,718	20,520	19,882
March	26,025	22,606	29,752	20,416	19,828
April	25,892	22,562	29,782	20,007	19,472
May	25,682	22,557	29,870	19,897	19,306
June	25,960	22,514	30,012	20,287	19,499
July	26,123	22,366	30,165	19,653	18,868
August	26,322	22,226	30,167	19,526	18,882
September	26,410	22,176	30,328	19,552	18,834
October	26,514	22,102	30,366	19,536	18,784
November	26,413	22,057	30,555	19,718	19,034
December	27,107	22,028	30,968	19,920	19,227
1954—January	26,243	22,015	30,282	20,179	19,243
February	25,746	21,957	29,903	19,557	18,925
March	25,553	21,963	29,800	19,573	18,881
April	25,483	21,966	29,755	19,392	18,627
May	25,503	21,971	29,773	19,533	18,817
June	25,876	21,927	29,856	19,670	18,813
July	25,571	21,926	29,968	19,164	18,329
August	24,855	21,871	29,896	18,478	17,638
September	24,838	21,809	29,991	18,403	17,628
October	25,459	21,787	30,078	18,893	18,173
November	25,776	21,724	30,287	19,207	18,393
December	26,317	21,711	30,749	19,279	18,576

Source: Board of Governors of the Federal Reserve System.

income rose from 7.8 to 8.5 percent. In the first quarter of 1954 consumer expenditures for commodities continued at the reduced level of the previous quarter, while national security expenditures dropped by more than $3 billion. By March 1954 the index of industrial production declined 10 percent from its July 1953 peak and nearly 6 percent of the civilian labor force was unemployed in March as compared with 3 percent a year earlier. Despite these and other deflationary pressures which have been known to exert a cumulative downward push on the economy, the gross national product reached its low in the second quarter, advanced moderately in the third, and rose sharply in the last quarter of the year.

TABLE 20.—*Member bank excess reserves, borrowings, and free reserves, 1953–54*

[Averages of daily figures, millions of dollars]

Period	Excess reserves	Borrowings at Federal Reserve banks	Free reserves
1953—January	707	1,347	−640
February	638	1,310	−672
March	588	1,202	−614
April	535	1,166	−631
May	591	944	−353
June	787	423	364
July	784	418	366
August	643	650	−7
September	718	468	250
October	752	363	389
November	684	487	197
December	693	441	252
1954—January	936	100	836
February	632	293	339
March	692	189	503
April	765	139	626
May	716	155	561
June	858	146	712
July	836	66	770
August	839	115	724
September	775	67	708
October	720	82	638
November	814	164	650
December	704	246	458

Source: Board of Governors of the Federal Reserve System.

There were various influences originating in the private and the governmental sectors of the economy that contributed to the relative mildness of the 1953–54 business recession. In the private sector there were such favorable factors as the maintenance of consumer spending at a high level. After dropping at the annual rate of nearly $2 billion in the fourth quarter of 1953, personal consumption expenditures rose at an annual rate of $1.4 billion in the first quarter of 1954, $3 billion in each of the next 2 quarters, and $4.5 billion in the last quarter. Personal saving, which was at its highest in the last 3 months of 1953 and in the first 3 months of 1954, dropped substantially during the remainder of the year with a fourth-quarter level that was $4 billion less than the peak reached a year earlier. Another factor in the private economy that exerted a stabilizing influence and hastened business recovery was the pace of residential construction which stepped up with each succeeding quarter of 1954. Both the reduction of the personal income tax that became effective in January 1954 and the decision of consumers to maintain a lower rate of saving contributed to the rise in consumer expenditures. Apart from the offsetting effect of the "automatic stabilizers," such as unemployment insurance

and the decline in taxpayments, there was also the favorable influence of the rise in State and local government expenditures all through the period of contraction. In addition to these and other factors of a contracyclical nature that might have been listed, there was the significant contribution of the monetary factor. Let us now turn to the role which credit policy played during this period.

TABLE 21.—*Deposits and currency, 1953–54*

[Billions of dollars]

End of period	Deposits and currency				
	Total [1]	Demand deposits and currency			Time deposits [3]
		Total	Demand deposits adjusted [2]	Currency outside banks	
1953—January	193.3	127.3	100.5	26.8	66.1
February	191.6	125.2	98.3	26.9	66.4
March	191.0	124.3	97.4	26.9	66.8
April	192.2	125.0	98.0	27.0	67.2
May	192.1	124.5	97.5	27.0	67.6
June	192.6	124.3	96.9	27.4	68.3
July	193.0	124.6	97.4	27.2	68.4
August	193.4	124.8	97.5	27.3	68.7
September	194.3	125.2	97.7	27.5	69.1
October	197.3	127.7	100.3	27.4	69.6
November	197.4	128.1	100.2	27.9	69.3
December	200.9	130.5	102.5	28.1	70.4
1954—January	199.8	129.2	102.3	26.9	70.6
February	197.4	126.5	99.6	26.9	71.0
March	195.2	123.6	96.7	26.9	71.7
April	197.3	125.3	98.6	26.7	72.0
May	198.0	125.5	98.7	26.8	72.5
June	198.5	125.2	98.1	27.1	73.3
July	200.4	126.8	100.0	26.8	73.7
August	200.3	126.3	99.4	26.9	74.0
September	202.5	128.1	101.2	26.9	74.4
October	204.7	130.0	103.1	26.9	74.8
November	205.8	131.5	104.0	27.5	74.3
December	209.7	134.4	106.6	27.9	75.3

[1] Includes holdings of State and local governments, but excludes U. S. Government deposits.
[2] Includes demand deposits, other than interbank and U. S. Government, less cash items in process of collection.
[3] Includes deposits in commercial banks, mutual savings banks, and Postal Savings System, but excludes interbank deposits.

Source: Board of Governors of the Federal Reserve System.

THE POLICY OF CREDIT EASE

We have seen that the Federal Reserve authorities shifted from a policy of restraint to credit ease shortly before the general business contraction had begun and that this change was not initiated as an antirecession move.[8] Nevertheless, in increasing their holdings of Government securities by $1 billion between May and July and then lowering reserve requirements in July, commercial banks entered the recession without the fears of uncertainty about Federal Reserve policy that seemed to be created by official pronouncements of a noninterventionist philosophy of the free market. The actions taken by the Federal Reserve also had the immediate tangible effect of greatly reducing member bank borrowing so that by January 1954 all mem-

[8] The 1953 Annual Report of the Board of Governors of the Federal Reserve System records only 2 meetings of the Open Market Committee during the first half of the year, March 4–5 and June 11. It was at the June meeting that the credit policy directive was changed from "exercising restraint upon inflationary developments" to "avoiding deflationary tendencies without encouraging a renewal of inflationary developments."

ber bank indebtedness at the Reserve banks was virtually eliminated—a condition that continued during most of the year. This was accompanied by a sharp decline in interest rates until at least mid-1954.

TABLE 22.—*Loans and investments of all commercial banks, 1953–54*

[Billions of dollars]

End of period [1]	Total loans and investments	Loans		Investments		
		Total [2]	Business loans [3]	Total	U. S. Government obligations [4]	Other securities
1953—January	140.8	63.9	27.5	77.0	62.8	14.2
February	140.1	64.1	27.4	76.0	61.9	14.1
March	140.0	65.2	27.9	74.8	60.5	14.3
April	138.5	65.3	27.8	73.3	58.9	14.4
May	138.1	65.4	27.6	72.7	58.3	14.4
June	138.0	65.0	27.4	72.9	58.6	14.3
July	143.2	65.6	27.5	77.5	63.2	14.3
August	143.1	66.0	27.7	77.1	62.6	14.5
September	143.0	66.3	27.9	76.7	62.2	14.5
October	144.0	67.1	27.9	76.8	62.3	14.5
November	145.5	67.3	27.8	78.3	63.7	14.6
December	145.7	67.6	27.2	78.1	63.4	14.7
1954—January	145.3	66.5	26.6	78.9	64.2	14.7
February	144.9	66.9	26.4	78.0	63.0	15.0
March	142.8	67.1	26.7	75.8	60.7	15.1
April	144.1	66.8	26 2	77.3	62.1	15.2
May	145.7	67.1	26.0	78.6	63.3	15.3
June	146.4	67.3	26.1	79.0	63.5	15.5
July	147.3	67.3	25.8	80.0	64.3	15.7
August	149.5	66.5	25.8	83.0	67.3	15.7
September	150.6	67.3	26.1	83.3	67.3	16.0
October	154.0	67.7	26.2	86.3	70.2	16.1
November	155.7	69.5	26.6	86.3	70.1	16.2
December	155.9	70.6	26.9	85.3	69.0	16.3

[1] June and December figures are for call dates. Other data are for the last Wednesday of the month.
[2] Data are shown net, i. e., after deduction of valuation reserves. Includes commercial and industrial, agricultural, security, real estate, bank, consumer, and other loans.
[3] Data are shown gross of valuation reserves. For months other than June and December data are estimated on the basis of reported data for all insured commercial banks and for weekly reporting member banks.
[4] Figures are based on book values and relate only to banks within the continental United States.

Source: Board of Governors of the Federal Reserve System.

In pursuing a policy of active ease after mid-1953, all three major instrumentalities of Federal Reserve credit policy were employed to facilitate economic recovery—open-market operations, the discount rate and reserve requirements. Between July and December 1953, there was an additional increase of nearly $700 million in Federal Reserve holdings of Government securities. At the beginning of February 1954 the discount rate was lowered from 2 percent to 1¾ percent and in April-May the rate was lowered to 1½ percent. In June-July, reserve requirements against demand deposits were reduced 2 percentage points at central Reserve cities; in July, 1 percentage point at Reserve city banks and a similar reduction in August at country banks; there was also a reduction in June of 1 percentage point on time deposits at member banks. These reductions released approximately $1.6 billion of reserves. Since member banks were supplied with more reserves than were needed at the time, the freed reserves were offset in part by a reduction in Federal Reserve holdings of Government securities of about $1 billion during the next 2 months. However, for the remainder of the year, open-market purchases of nearly $1 billion provided the banks with additional reserves for credit and monetary expansion. The progressive easing of the reserve position of member

banks is evidenced by the fact that their free reserves averaged $279 million in the fourth quarter of 1953, $559 million in the first quarter of 1954, $633 million in the second and $734 million in the third quarter.

The policy of active ease resulted in a marked decline in interest rates. The average rate on Treasury bills dropped from a peak of 2.23 percent in June 1953 to a low of 0.65 percent in June 1954. The rate on prime commercial paper fell from its peak of 2.75 percent in 1953 to 1.33 percent in August 1954 and remained at this level for the rest of the year. In contrast to these sharp declines was the sluggish movement of the average rate on short-term bank loans to business firms. Customer loan rates moved from a peak of 3.76 percent in December 1953 to 3.60 percent in June 1954 and to 3.55 percent at the end of the year.

TABLE 23.—*Loans and investments of all commercial banks, 1950–57*

[Millions of dollars]

Call date	Total loans and investments (excluding interbank)	Loans [1]							Investments		
		Total loans (excluding interbank)	Business	Agriculture	Securities	Real estate	Consumer	All other	Total	U. S. Government securities	Other securities
Dec. 30, 1949	120,099	42,867	17,060	3,051	2,637	11,542	5,777	3,357	77,232	67,005	10,227
June 30, 1950	121,665	44,694	16,947	2,896	2,804	12,412	6,613	3,613	76,972	65,751	11,221
Dec. 31, 1950	126,585	52,159	21,927	2,905	2,859	13,541	7,374	4,228	74,426	62,027	12,399
June 30, 1951	125,890	54,666	23,651	3,122	2,644	14,144	7,425	4,395	71,224	58,521	12,703
Dec. 31, 1951	132,461	57,597	25,879	3,408	2,561	14,580	7,455	4,528	74,863	61,524	13,339
June 30, 1952	134,284	59,080	25,312	3,651	3,078	15,019	8,256	4,616	75,204	61,178	14,026
Dec. 31, 1952	141,467	64,006	27,870	3,919	3,163	15,713	9,368	4,877	77,461	63,318	14,143
June 30, 1953	137,802	64,870	27,418	3,675	2,793	16,231	10,597	5,096	72,932	58,644	14,287
Dec. 31, 1953	145,525	67,431	27,204	4,965	3,563	16,694	10,897	5,068	78,094	63,426	14,668
June 30, 1954	146,208	67,162	26,120	5,143	3,718	17,227	10,760	5,185	79,046	63,508	15,538
Dec. 31, 1954	155,676	70,379	26,867	5,200	4,454	18,418	10,892	5,619	85,297	68,981	16,316
June 30, 1955	154,846	74,765	28,872	4,391	4,471	19,779	12,129	6,247	80,081	63,271	16,809
Dec. 31, 1955	160,307	82,027	33,245	4,475	5,037	20,809	13,236	6,492	78,280	61,592	16,688
June 30, 1956	159,344	86,223	36,111	4,254	4,433	21,787	14,168	6,819	73,122	56,620	16,502
Dec. 31, 1956	164,471	89,650	38,720	4,161	4,281	22,509	14,550	6,990	74,821	58,552	16,629
June 6, 1957	163,514	90,027	39,020	4,077	3,908	22,530	15,100	6,630	73,487	56,642	16,845
Dec. 31, 1957	169,346	93,177	40,526	4,066	4,221	23,110	15,809	7,219	76,169	58,239	17,930

[1] Figures for various loan items are shown gross (i. e., before deduction of valuation reserves); they do not add to the total. Total loans are shown net.

Source: Board of Governors of the Federal Reserve System.

In the long-term sector of the market, the yield on the 3¼-percent Treasury bond issued May 1, 1953, dropped to 2.6 percent in August 1954. High-grade municipal bonds moved downward from 2.99 percent in June 1953 to a low of 2.23 percent in August 1954, and Moody's Aaa corporate bonds declined from 3.40 percent in June 1953 to a low of 2.85 percent in May 1954. Apparently, in this period at least, proponents of the view that Federal Reserve credit policy should concentrate on the short-term sector of the market and that its influence would soon be felt in the long-term sector can point to the decline of yields on long-term securities in the 1953–54 period as supporting their position. It should be noted, however, that from high to low, the percentage decline of yields in the long-term sector was generally less than half the decline in the short-term sector. Relatively smaller fluctuations of yields in long-term as compared to short-term markets has characterized other periods when interest rates moved downward during business contractions.

BANK LOANS AND INVESTMENTS

Both the decline in business activity and the more ample bank reserves resulting from the easier Federal Reserve credit policy caused commercial banks to turn to the purchase of Government securities. In the last 6 months of 1953 they acquired $4.8 billion, in contrast to the sale of $4.7 billion in the first half of the year when they were under pressure to meet credit demands. Their holdings of Government securities changed little in the first half of 1954 but during the last half increased by $5.5 billion. The United States Government obligations of over $10 billion acquired since mid-1953 were partly from purchases of new Treasury securities and partly from nonbank holders. Thus, these acquisitions by the commercial banks provided funds to other financial institutions facilitating their expansion of loans for investment activity. This was especially the case with mortgage credit for housing, an area that contributed substantially to the mildness of the 1953–54 recession. Moreover, the absorption by commercial banks of Federal securities, especially during the second half of 1954, resulted in a sharp rise in demand deposits.

Another category of commercial bank investment which was a stimulus to recovery was the $2 billion increase in the holdings of "other securities," mainly State and local, between mid-1953 and the end of 1954. The long-term borrowing by State and local governments was largely for construction of highways, schools, and other community facilities.

Total commercial bank loans in the second half of 1953 increased less than in any corresponding 6-month period since 1950. During the next 9 months they remained lower than at the end of 1953, but in the last quarter of 1954 they expanded by over $3 billion. Two categories of loans showed a marked rise in 1954 and played a significant role in investment activity; namely, loans on real estate and for purchasing and carrying securities to brokers and dealers and to others.

TABLE 24.—*Mortgage debt outstanding, by type of property and of financing, 1950–57*

[Billions of dollars]

Period	All properties	Nonfarm properties							Farm properties
		Total	1- to 4-family houses					Multi-family and commercial properties	
			Total	Government underwritten			Conventional		
				Total	FHA insured	VA guaranteed			
1950—March	--------	--------	39.0	15.6	7.3	8.3	23.4	--------	--------
June	--------	--------	41.0	16.5	7.6	8.9	24.5	--------	--------
September	--------	--------	43.3	17.6	8.2	9.4	25.7	--------	--------
December	72.8	66.7	45.2	18.9	8.6	10.3	26.3	21.6	6.1
1951—March	75.0	69.1	46.9	20.0	8.9	11.1	26.9	22.2	6.0
June	77.8	71.6	48.7	21.0	9.2	11.8	27.7	23.0	6.2
September	79.9	73.6	50.4	22.0	9.5	12.5	28.4	23.3	6.3
December	82.3	75.6	51.9	22.9	9.7	13.2	29.0	23.9	6.7
1952—March	84.1	77.4	53.3	23.5	9.9	13.6	29.7	24.1	6.7
June	86.4	79.5	55.1	24.0	10.1	13.9	30.8	24.4	7.0
September	88.9	81.8	57.0	24.7	10.4	14.3	31.7	24.9	7.1
December	91.1	84.0	58 7	25.4	10.8	14.6	33.1	25.3	7.1
1953—March	93.4	86.0	60.3	26.1	11.1	15.0	34.2	25.7	7.3
June	96.1	88.6	62.4	26.7	11.4	15.3	35.7	26.2	7.5
September	98.7	91.1	64.3	27.5	11.7	15.8	36.8	26.7	7.6
December	101.3	93.6	66.1	28.1	12.0	16.1	38.0	27.5	7.8
1954—March	103.1	95.3	67.6	28.8	12.2	16.6	38.8	27.7	7.8
June	106.2	98.2	69.9	29.7	12.4	17.3	40.2	28.4	8.0
September	109.7	101.6	72.6	30.7	12.6	18.1	41.9	29.0	8.1
December	113.8	105.5	75.7	32.1	12.8	19.3	43.6	29.8	8.3
1955—March	117.2	108.8	78.5	33.5	13.2	20.3	45.0	30.3	8.4
June	121.8	113.2	82.2	35.3	13.5	21.8	46.9	31.0	8.7
September	126.1	117.2	85.5	37.0	13.9	23.1	48.5	31.8	8.8
December	130.0	120.9	88.2	38.9	14.3	24.6	49.3	32.7	9.1
1956—March	133.6	124.2	90.8	40.2	14.7	25.5	50.6	33.4	9.4
June	137.6	128.0	93.7	41.3	15.0	26.3	52.4	34.3	9.6
September	141.4	131.6	96.6	42.4	15.2	27.3	54.1	35.1	9.8
December	144.8	134.9	99.1	43.9	15.5	28.4	55.1	35.8	9.9
1957—March [1]	147.2	137.1	101.1	45.1	15.7	29.4	55.9	36.1	10.1
June [1]	150.2	129.9	103.3	45.9	15.9	30.0	57.4	36.6	10.3
September [1]	153.4	143.0	105.6	46.5	16.1	30.4	59.1	37.4	10.4
December [1]	156.3	145.8	107.6	47.2	16.5	30.7	60.4	38.2	10.5

[1] Preliminary.

Source: Board of Governors of the Federal Reserve System.

Real estate loans rose by $1.7 billion, more than one-half the rise of total bank loans in 1954. This was in response to the expansion in housing construction which started its upward climb in the fall of 1953 and accelerated its pace during the following year. There is little doubt that the easy money policy was a major factor in the 1954 housing boom. Both the greater availability of credit and the more liberal financing terms on FHA and VA mortgages spurred builders to increase the volume of home building. From September 1953 to December 1954 the total mortgage debt outstanding on nonfarm 1- to 4-family houses increased by $11.4 billion—a rise that was made possible by the adequacy of funds for mortgage investment by insurance companies, mutual savings banks, savings and loan associations, as well as by commercial banks.

The second largest 1954 increase in bank loans—nearly $1 billion—was for the purchase and carrying of securities. The expansion in the volume of stock market credit accompanied as well as stimulated increased stock market activity. Common stock prices began to rise in September 1953 and continued their uninterrupted upward course until January 1955—an increase of 50 percent with the most rapid

rise in the later months of 1954. The ample supply of bank credit spilled over into the stock market so that credit for trading showed the greatest increase during any of the postwar years. The buoyancy of the stock market, even while business activity was moving downward, was regarded by the investing public as indicating that the business recession would be mild and of short duration.

TABLE 25.—*Annual rate of turnover of demand deposits,*[1] *1953–54*

[Ratio of debits to deposits]

Period	New York City	6 other centers [2]	338 other reporting centers	Period	New York City	6 other centers [2]	338 other reporting centers
1953—January	34.3	23.9	18.4	1954—January	42.7	24.1	18.6
February	35.1	24.4	18.9	February	42.7	25.5	19.2
March	37.1	28.7	19.4	March	44.6	29.2	19.7
April	35.4	26.7	18.4	April	41.3	27.6	18.8
May	35.6	26.2	18.8	May	41.9	25.5	18.8
June	38.9	26.5	19.2	June	44.2	26.8	19.7
July	36.0	25.7	19.2	July	41.6	24.9	18.8
August	32.2	23.6	17.8	August	40.0	24.8	18.5
September	40.2	25.9	19.3	September	40.4	25.3	19.4
October	35.8	23.9	18.4	October	39.3	23.6	18.6
November	38.4	26.4	20.2	November	42.2	26.3	20.7
December	43.1	26.8	19.7	December	48.1	28.1	21.0

[1] Does not include interbank and U. S. Government deposits and is given without seasonal adjustment.
[2] Boston, Philadelphia, Chicago, Detroit, San Francisco, Los Angeles.

Source: Board of Governors of the Federal Reserve System.

Our review of economic and financial developments since mid-1953 indicates that Federal Reserve credit policy contributed substantially to moderating the recession and supporting economic recovery. The shift to a policy of active ease played an important part in making credit more available and in lowering its cost. With more ample reserves and greater liquidity banks sought out new business more aggressively and greatly expanded their investment portfolios. The chief beneficiary was the construction industry—especially housing, commercial and public works construction. Toward the end of 1954 even credit for the consumer durable goods industry, which had declined during the first half of 1954, began to move up sharply.

Monetary policy would not have been so powerful an influence in recovery if the level of consumer spending had not remained so high and if other antirecession measures had not been undertaken promptly by the Federal Government. It has been said that monetary policy was too liberal in this period and created difficult problems after the business upswing in the fall of 1954 gathered much greater momentum in the following year. This and related questions concerning the role of monetary policy in economic stabilization are discussed in the next chapter.

Chapter III. Federal Reserve Policy, 1955–57

THE KEY IMPORTANCE OF 1955 IN RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS

For understanding the character of the business expansion from the fall of 1954 to the summer of 1957 and of the role of monetary policy in these developments, no single year is so illuminating as 1955. It was in this year that the expansion assumed its most rapid rate of increase and the amount of private indebtedness rose at a record rate. The acceleration in the pace of production and in the volume of credit posed a series of problems for the monetary authorities that are central in any consideration of the role of monetary policy in economic stabilization.

The rapidity of the expansion in economic activity in 1955 is indicated by the index of industrial production which moved from a low of 123 in August 1954, to 130 in December and advanced to 144 by December 1955. Only during 1 month of 1956 and 1 month of 1957 did the index generally exceed the December 1955 level by 2 points. The gross national product increased by nearly $35 billion in 1955, $22 billion in 1956, and $15 billion in the first 9 months of 1957.

Table 26.—*Indexes of industrial production, wholesale and consumer prices, 1955–57*

[1947–49=100]

Month	Industrial production [1]	Wholesale prices	Consumer prices	Month	Industrial production [1]	Wholesale prices	Consumer prices
1955—January	132	110.1	114.3	1956—July	136	114.0	117.0
February	133	110.4	114.3	August	143	114.7	116.8
March	135	110.0	114.3	September	144	115.5	117.1
April	136	110.5	114.2	October	146	115.6	117.7
May	138	109.9	114.2	November	146	115.9	117.8
June	139	110.3	114.4	December	147	116.3	118.0
July	139	110.5	114.7	1957—January	146	116.9	118.2
August	140	110.9	114.5	February	146	117.0	118.7
September	142	111.7	114.9	March	145	116.9	118.9
October	143	111.6	114.9	April	143	117.2	119.3
November	143	111.2	115.0	May	143	117.1	119.6
December	144	111.3	114.7	June	144	117.4	120.2
1956—January	143	111.9	114.6	July	144	118.2	120.8
February	143	112.4	114.6	August	145	118.4	121.0
March	141	112.8	114.7	September	144	118.0	121.1
April	143	113.6	114.9	October	141	117.8	121.1
May	141	114.4	115.4	November	139	118.1	121.6
June	141	114.2	116.2	December	135	118.5	121.6

[1] Seasonally adjusted.

Source: Board of Governors of the Federal Reserve System and U. S. Department of Labor.

The main impetus to the speedy pace of the economic recovery after the summer of 1954 came from residential construction and automobile production. Between the third quarter of 1954 and the first quarter of 1955 disposable personal income rose at an annual rate of $7 billion, while consumption expenditures increased at the rate of $10.7 billion. Personal saving as a percent of disposable income fell

from 7.0 to 5.5 percent. During this 6-month period consumer expenditures for durable goods rose by $5.9 billion. Expenditures on nonfarm residential construction, which began to rise in the second quarter of 1954, advanced to a level that was $4.2 billion higher by the second quarter of 1955. Thus, the consumer played a powerful role in the speed of business recovery. The liberality of credit terms and the rise in the volume of credit for the purchase of homes and automobiles were also powerful influences in the economic expansion. The mortgage debt on 1- to 4-family houses, which had risen by $9.6 billion in 1954, increased by $12.5 billion in 1955. Consumer installment credit rose by about $5.5 billion during 1955.

TABLE 27.—*Gross national product, seasonally adjusted at annual rates, 1955–57*

[Billions of dollars]

	1955				1956				1957			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Gross national product	384.3	393.0	403.4	408.9	410.8	414.9	420.5	430.5	436.3	441.2	445.6	438.9
Personal consumption expenditures	249.4	254.3	260.9	263.3	265.2	267.2	269.7	275.4	279.8	282.5	288.3	287.2
Durable goods	38.2	39.1	41.4	39.8	38.7	37.8	37.5	39.5	40.2	39.5	40.4	39.6
Nondurable goods	121.2	123.7	126.1	128.1	129.6	130.9	131.6	133.4	135.5	137.1	140.5	138.8
Services	90.0	91.6	93.4	95.3	96.9	98.6	100.6	102.5	104.1	105.9	107.4	108.7
Gross private domestic investment	58.8	63.1	65.4	67.6	68.0	67.7	68.1	68.8	65.9	67.0	66.7	61.5
New construction	33.9	34.9	35.4	35.4	35.2	35.8	35.8	36.2	36.1	36.1	36.6	37.1
Residential nonfarm	18.5	18.9	18.9	18.4	17.8	17.7	17.6	17.7	17.2	16.5	16.9	17.6
Other	15.4	16.0	16.5	17.0	17.4	18.1	18.3	18.4	18.9	19.6	19.7	19.6
Producers' durable equipment	20.5	22.1	24.4	25.4	25.9	26.6	27.3	28.2	28.7	28.1	28.0	26.7
Change in business inventories: total	4.4	6.1	5.7	6.7	6.9	5.4	4.9	4.4	1.1	2.9	2.2	−2.3
Nonfarm only	3.8	5.7	5.5	6.7	7.4	6.2	5.3	4.6	.6	2.0	1.3	−3.1
Net foreign investment	−.5	−.8	.1	−.5	−.5	1.3	2.0	2.8	4.2	4.2	3.6	1.9
Government purchases of goods and services	76.5	76.4	77.0	78.5	78.1	78.7	80.8	83.4	86.4	87.5	87.0	88.3
Federal	47.0	46.2	46.5	47.5	46.1	46.0	47.4	49.1	50.5	51.5	50.9	50.5
National security	41.9	41.1	41.0	41.2	41.2	41.4	43.0	44.5	45.8	47.4	46.9	46.0
Other	5.5	5.6	5.8	6.8	5.4	5.0	4.7	5.0	5.1	4.5	4.5	5.0
Less Government sales	.4	.4	.4	.4	.4	.4	.4	.4	.4	.4	.5	5
State and local	29.5	30.2	30.5	31.0	32.0	32.7	33.4	34.4	35.9	36.0	36.1	37.8

Source: Department of Commerce.

The continuous business upswing in 1955 was associated with an increasing accumulation of inventories, from an annual rate of less than $1 billion in the last 3 months of 1954 to $6.7 billion in the last 3 months of 1955. Another major stimulus to the 1955 expansion was the rise of business investment in plant and equipment, beginning in the second quarter and accelerating in the latter half of the year. To a considerable extent the sharp rise in business investment was induced by the upsurge in consumer demand for durable goods and housing.

The marked expansion of business activity in 1955 was accompanied by very little rise either in the index of wholesale prices or the index of consumer prices. While industrial prices in wholesale markets rose 3½ percent in the second half of 1955, this rise was largely offset by the decline in farm prices. If the increasing exuberance of the

economy since the fall of 1954 was not reflected in the general level of commodity prices at wholesale or retail during 1955, it was registered in the acceleration in the rise of common stock prices in the last 3 months of 1954—a rise that had been continuing for a year. Stock prices climbed upward with a few interruptions all through 1955, although at a slower pace than in the preceding year.

TABLE 28.—*Disposition of disposable personal income, 1955–57*

[Seasonally adjusted quarterly totals at annual rates]

[Billions of dollars]

Period	Disposable personal income	Personal consumption expenditures	Personal saving	Saving as percent of disposable personal income
1955—1st quarter	263.8	249.4	14.4	5.4
2d quarter	272.0	254.3	17.8	6.6
3d quarter	277.7	260.9	16.8	6.0
4th quarter	283.0	263.3	19.8	7.0
1956—1st quarter	283.1	265.2	17.9	6.3
2d quarter	288.8	267.2	21.6	7.4
3d quarter	292.1	269.7	22.4	7.7
4th quarter	297.2	275.4	21.7	7.3
1957—1st quarter	300.0	279.8	20.3	6.8
2d quarter	305.7	282.5	23.2	7.6
3d quarter	308.7	288.3	20.4	6.6
4th quarter	306.8	287.2	19.6	6.4

Source: Department of Commerce.

THE STOCK MARKET AND MARGIN REQUIREMENTS

We have seen in the previous chapter that the monetary authorities pursued a liberal credit policy which encouraged banks to lend more freely. One sector that took advantage of the increasing credit opportunities was the stock market. During 1954 bank credit extended to brokers and dealers increased by nearly $1 billion. Loans on margin accounts by brokers and dealers to their customers increased by about the same amount, with the greatest rise taking place in the second half of the year.

The first restrictive credit move by the Federal Reserve Board was the raising of margin requirements from 50 to 60 percent at the beginning of January 1955. As measured by Standard & Poor's index of 500 stocks, their average price rose by more than 50 percent between September 1953 and January 1955. In addition to about a 50-percent rise in stock-market credit, there was increasing evidence of speculative activity in the market during the latter half of 1954. It was these developments which led the Federal Reserve Board to act on January 4, as well as the Senate Banking and Currency Committee to decide on January 14 upon a study of the stock market. Past experience has shown that continuously rising stock prices generate an optimistic psychology that is transmitted to other areas than the stock market, resulting in widespread overconfidence and to excesses that can jeopardize economic stability. The Banking Committee's public hearings were held during the first 3 weeks in March and were widely reported in the daily press. Practically every one of the 21 prominent witnesses who testified expressed some concern about 1 or more of the speculative tendencies that had appeared in the stock

market. On the basis of its hearings, the Committee "was of the view that conditions in January warranted more vigorous action to curb stock-market credit by the Federal Reserve Board" than the 10-point rise in margin requirements.[1] It is also significant to note that the Committee pointed out that the liberality of credit in other areas than the stock market might be a potential threat to economic stability:[2]

> * * * A number of witnesses stressed the dangers in over-extension of credit in the mortgage market and the possibility that the recent rate of housing construction may not be sustainable for very long. Likewise, concern was expressed about the high level of consumer credit and the ability of the automobile industry to maintain current levels of production during the second half of the year * * *

On April 23, 1 month after the close of the Senate Banking Committee's hearings, the Federal Reserve Board raised margin requirements from 60 to 70 percent.[3] After the second action was taken, the rate of increase in stock-market credit declined substantially.

CREDIT EXPANSION IN 1955

Between the third quarter of 1954 and the first quarter of 1955 the gross national product advanced at an annual rate of $22.3 billion; about two-thirds of the increase was due to the sharp expansion in outlays for consumer durable goods, continued advances in purchase of new homes, and a shift from liquidation to accumulation in business inventories. The speedy economic recovery which received its major impetus from these sectors was accompanied by a substantial rise in credit and by a considerable easing in financial terms, especially longer maturities and lower downpayments on installment and mortgage credit. Business loans of commercial banks which usually decline in the first half of the year increased by $2 billion in the first 6 months of 1955. In the second quarter of the year, installment credit outstanding expanded by nearly $2 billion, a record increase in so short a period. The mortgage debt outstanding on 1- to 4-family homes increased by $6.5 billion during the first 6 months of 1955 as compared to $3.8 billion in the corresponding period of 1954.

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[1] Stock Market Study: Report together with the individual views and minority views of the Committee on Banking and Currency, Senate, 84th Cong., 1st sess., May 26, 1955, p. 7.
[2] Ibid., p. 13.
[3] It is of interest to note that when Mr. Martin, Chairman of the Federal Reserve Board, testified on March 14, 1955, at the hearings on the stock-market study he was questioned at considerable length about the adequacy of the January change in margin requirements by Mr. Fulbright, chairman of the Senate Banking and Currency Committee.

TABLE 29.—*Loans and investments of all commercial banks, 1955–57*

[Billions of dollars]

End of period [1]	Total loans and investments	Loans		Investments		
		Total [2]	Business [3]	Total	U. S. Government obligations [4]	Other securities
1955—January	156.3	70.6	26.6	85.7	69.0	16.7
February	154.8	71.2	26.8	83.6	66.8	16.8
March	153.5	72.3	27.4	81.2	64.2	17.0
April	155.5	72.9	27.6	82.6	65.6	17.0
May	155.6	73.9	28.0	81.7	65.0	16.7
June	155.3	75.2	28.9	80.1	63.3	16.8
July	157.0	76.6	29.1	80.4	63.7	16.7
August	156.7	77.3	29.9	79.4	62.5	16.9
September	157.3	78.4	30.5	78.9	62.0	16.9
October [5]	158.9	79.2	31.1	79.7	62.9	16.8
November	159.4	81.4	32.3	78.0	61.4	16.6
December	160.9	82.6	33.2	78.3	61.6	16.7
1956—January	159.4	82.0	32.7	77.4	60.9	16.5
February	158.4	82.5	32.9	75.8	59.2	16.6
March	159.9	84.7	34.5	75.2	58.6	16.6
April	160.1	85.3	34.8	74.8	58.2	16.6
May	159.7	86.0	34.8	73.7	57.3	16.4
June	160.0	86.9	36.1	73.1	56.6	16.5
July	159.6	87.1	35.8	72.5	56.2	16.3
August	161.0	87.5	36.4	73.6	57.2	16.4
September	162.0	88.5	37.0	73.6	57.0	16.6
October	162.5	88.8	37.2	73.8	57.5	16.3
November	164.0	89.5	37.8	74.5	58.2	16.3
December	165.1	90.3	38.7	74.8	58.6	16.3
1957—January	162.8	88.9	37.6	73.9	57.7	16.2
February	162.5	89.3	37.8	73.1	56.8	16.3
March	162.9	90.6	39.0	72.2	55.7	16.5
April	165.1	91.0	39.0	74.2	57.5	16.7
May	165.1	91.2	38.9	73.9	57.1	16.8
June	165.6	93.3	40.5	72.3	55.5	16.8
July	165.4	92.3	39.6	73.1	56.3	16.8
August	165.9	92.8	39.9	73.1	56.2	16.9
September	166.3	93.4	40.3	73.0	55.9	17.1
October	167.9	93.0	39.7	74.9	57.3	17.6
November	167.3	92.9	39.6	74.3	56.9	17.4
December	170.1	93.9	40.5	76.2	58.2	17.9

[1] June and December 1956, and December 1957, figures are for call dates. Other data (including those for June 1957) are for the last Wednesday of the month.

[2] Data are shown net, i. e., after deducting valuation reserves. Includes commercial and industrial, agricultural, security, real estate, bank, consumer, and other loans.

[3] Data are shown gross of valuation reserves. For months other than June and December data are estimated on the basis of reported data for all insured commercial banks and for weekly reporting member banks.

[4] Figures are based on book values and relate only to banks within the continental United States.

[5] For October 1955 certain loan items are available on 2 bases because of a reclassification resulting from reporting errors. The business loans figure shown above is after reclassification. The figure before reclassification is $30.8 billion.

Source: Board of Governors of the Federal Reserve System.

Commercial banks played a powerful role in the speedy economic recovery in the first half of 1955 through their expansion of credit for housing and consumer durables. Bank loans increased by $4½ billion—a record for the January–June period since World War II. During these 6 months, there was an increase of $1.3 billion in real-estate loans, $1.2 billion in consumer loans, and $2 billion in business loans of which a substantial part was for sales finance companies.[4] In order to meet the increasing demands for loans, the banks reduced their holdings of United States Government securities by $5.7 billion in the first half of the year. There was also some rise in bank borrowing from the Federal Reserve banks—an increase from a monthly average of $160 million in the last quarter of 1954 to an average of about $400 million in the first half of 1955.

[4] See table 23, p. 37.

TABLE 30.—*Deposits and currency, 1955–57*

[Billions of dollars]

End of period	Deposits and currency				
	Total [1]	Demand deposits and currency			Time deposits [3]
		Total	Demand deposits adjusted [2]	Currency outside banks	
1955—January	209.2	133.8	107.0	26.8	75.4
February	206.9	131.3	104.5	26.8	75.7
March	205.3	129.1	102.4	26.7	76.2
April	207.4	131.2	104.5	26.7	76.2
May	206.7	130.1	103.3	26.8	76.5
June	207.7	130.6	103.2	27.3	77.1
July	208.1	131.0	103.9	27.1	77.1
August	208.6	131.2	103.9	27.4	77.4
September	209.7	132.1	104.9	27.2	77.7
October	211.3	133.4	106.1	27.3	77.9
November	212.2	134.8	106.9	27.9	77.4
December	216.6	138.2	109.9	28.3	78.4
1956—January	214.4	136.0	108.9	27.1	78.4
February	211.6	132.8	105.6	27.2	78.8
March	210.8	131.6	104.4	27.2	79.3
April	212.4	133.1	106.1	27.0	79.3
May	211.2	131.6	104.2	27.4	79.6
June	213.6	133.0	104.7	28.3	80.6
July	213.3	132.6	105.2	27.4	80.7
August	212.8	132.0	104.5	27.5	80.9
September	214.1	132.8	105.4	27.4	81.3
October	216.6	135.1	107.4	27.7	81.5
November	217.2	136.3	108.3	28.0	80.9
December	222.0	139.7	111.4	28.3	82.2
1957—January	219.9	136.9	109.5	27.4	82.9
February	218.0	134.4	107.0	27.4	83.6
March	217.2	132.6	105.2	27.4	84.6
April	219.6	134.7	107.3	27.4	84.9
May	218.4	132.7	104.8	27.9	85.7
June	219.7	133.4	105.6	27.8	86.4
July	221.0	134.4	106.6	27.8	86.7
August	220.0	132.9	105.1	27.8	87.1
September	220.9	133.3	105.5	27.8	87.7
October	223.0	135.0	107.2	27.8	88.1
November	223.3	135.7	107.2	28.5	87.6
December	227.7	138.6	110.3	28.3	89.1

[1] Includes boldings of State and local governments, but excludes U. S. Government deposits.
[2] Includes demand deposits, other than interbank and U. S. Government, less cash items in process of collection.
[3] Includes deposits in commercial banks, mutual savings banks, and Postal Savings System, but excludes interbank deposits.

Source: Board of Governors of the Federal Reserve System.

In the second half of the year, bank loans increased by $7.4 billion with three-fifths of the advance occurring in the category of business loans. The rise in consumer loans was the same as in the first part of the year, and real estate loans advanced at a somewhat slower pace than during the first 6 months. As a result of the pressure for funds, bank borrowing at the Federal Reserve banks during the last quarter of the year averaged $900 million.[5]

A $12 billion increase in bank loans in 1955 was offset by the sale of Government securities in the amount of $7.4 billion. Commercial bank sales of United States Government obligations were absorbed by nonfinancial corporations, pension and trust funds, State and local govern-

[5] It is of some interest to note that the amount of borrowing during the latter part of 1955 and right through 1957 did not reach the level of the earlier 1952–53 period of tight credit. Part of the explanation lies in the fact that in recent years the banks turned increasingly to the Federal funds market for adjusting their reserves. More intensive use was made of existing reserves since banks with a deficiency of reserve balances borrowed from those with excess reserves. Another explanation is that Federal Reserve borrowing in 1952–53 could be included with other borrowed capital in calculating a bank's excess profits tax liability. In June 1953 the excess profits tax expired.

ments, and individual investors. Largely because of the contrary movement of bank loans and investments, there was a rise in demand deposits of only $3.4 billion.

Although the money supply increased moderately during 1955, the velocity of circulation rose substantially. Demand deposits and currency outside banks increased at the rate of 2.8 percent as compared to a 3 percent rise in 1954. However, the average annual rate of turnover of demand deposits outside New York City increased by nearly 7 percent between 1954 and 1955.

TABLE 31.—*Annual rate of turnover of demand deposits, 1955–57* [1]

[Ratio of debits to deposits]

Period	New York	6 other centers [2]	337 other reporting centers [3]	Period	New York	6 other centers [2]	337 other reporting centers [3]
1955—January	42.0	25.4	19.6	1956—July	45.9	29.6	22.4
February	41.9	26.4	19.6	August	44.4	27.4	21.3
March	41.7	30.2	20.0	September	44.8	27.4	22.0
April	37.3	27.1	19.2	October	45.2	28.4	22.1
May	42.7	28.4	20.6	November	48.3	31.0	23.6
June	44.7	28.3	20.8	December	51.8	29.9	23.3
July	40.7	26.6	20.4	1957—January	48.3	30.0	22.9
August	38.2	25.9	19.9	February	48.9	30.2	23.0
September	43.5	27.4	21.1	March	48.7	32.0	22.5
October	44.7	26.5	20.3	April	46.9	30.3	22.4
November	45.4	29.0	22.0	May	47.1	30.5	23.2
December	51.3	28.1	21.6	June	51.4	30.4	23.1
1956—January	45.7	29.5	21.7	July	49.5	30.6	23.6
February	41.1	27.5	21.0	August	44.7	28.5	22.1
March	47.2	29.7	20.8	September	52.2	31.4	24.1
April	45.4	30.1	21.5	October	49.9	29.6	22.7
May	46.0	28.7	21.7	November	51.2	30.5	23.5
June	47.0	28.9	21.6	December	58.9	32.2	24.7

[1] Does not include interbank and U. S. Government deposits and is given without seasonal adjustment.
[2] Boston, Philadelphia, Chicago, Detroit, San Francisco, Los Angeles.
[3] Before April 1955, 338 other reporting centers.

Source: Board of Governors of the Federal Reserve System.

The increase in the demand for funds and the growing pressure on bank reserve positions was reflected in the rise of interest rates. The yield on Treasury bills, which averaged 0.65 percent in June 1954 and rose to 1.17 percent by December, advanced to 2.6 percent in December 1955. The rate on 4-to-6 months' prime commercial paper rose sharply during 1955, from 1.47 percent in January to 3 percent in December. Long-term rates in 1955 advanced much less than short-term rates. Between December 1954 and December 1955, yields on Government 10- to 20-year taxable bonds rose from 2.57 percent to 2.88 percent, and Moody's Aaa corporate bonds advanced from 2.90 percent to 3.15 percent.

POLICY DIRECTIVES OF THE OPEN MARKET COMMITTEE [6]

In view of the pace of economic and credit expansion during 1955, let us see how the Open Market Committee regarded the changing situation and how it dealt with it. On January 11 it revised its directive to the Executive Committee from "maintaining a condition of ease in the money market" to "maintaining conditions in the money market that would encourage recovery and avoid the development of unsustainable expansion." However, the change in directive "did not

[6] The policy actions of the Open Market Committee referred to in this section are recorded in the Forty-second Annual Report of the Board of Governors of the Federal Reserve System, 1955, pp. 89–111.

call for pursuit at this stage of a program of credit restraint or of firmness in the money market." At its meeting of March 2, the Committee noted "that expansive forces had continued generally strong, both domestically and abroad," but concluded that the "situation did not appear to call for a generally restrictive credit policy." It is interesting to note that the record of this meeting states that—

> concern was indicated with respect to the relaxation of terms for, and the volume of expansion in, mortgage and consumer credit, and there were some fears that in a few industries, including building, activity was reaching levels that could not be sustained.

In the light of this recognition of the potential dangers arising from the two sectors of the economy that played so significant a part in the rate of economic expansion during the rest of the year, one may be puzzled at the Committee's conclusion that "further measures toward restraint should be deferred until the effects of the shift in operations that had taken place since the beginning of the year were more apparent." The credit restraint referred to was the reduction in January and February of Federal Reserve holdings of United States Government securities by $1.3 billion. But this reduction was primarily for the purpose of absorbing reserve funds that normally become available to commercial banks by the seasonal return of currency from circulation and by the seasonal decline in deposits. The sale of Government securities by the Federal Reserve banks may have been larger than usual in recognition of the increasing demand for bank credit. But the amount of such sale in excess of the seasonally "normal" was small and could exert—as it was intended to do—only a very moderate influence in tightening bank reserves.

It was not until its meeting of May 10 that the Open Market Committee revised its January directive by deleting the words "encourage recovery." Since "recovery now was an accomplished fact," the credit policy was to aim at "maintaining conditions in the money market that would avoid the development of unsustainable expansion." Among the various developments in the economy, it noted that the gross national product had risen substantially since its 1954 low and had exceeded its mid-1953 peak; a number of industries were operating at or close to capacity; business, financial, and consumer confidence was extraordinarily high; there had been no seasonal contraction in business loans, and the rapid expansion of real estate and consumer loans had continued. In its meeting of June 22, the Committee referred to new record levels in economic activity, but expressed some concern that the high level of production and employment had been supported by rapid expansion in consumer and mortgage credit on easy terms and that there was the likelihood of prices moving upward.

> There appeared to be little leeway for further increases in production, and it was doubtful that productivity could be increased rapidly enough to counteract cost-price influences.

In view of the fact that the monetary authorities recognized around the beginning of May, and even more so by the end of June, that overall economic activity was reaching boom proportions, it was surprising even in financial circles that the Reserve banks waited until mid-April

and early May to raise the discount rate from 1½ to 1¾ percent.[7] The new 1¾ rate was below the discount rate at the beginning of 1953, and it was not until early in August that the 2 percent rate established in January 1953 was reached. Since the gross national product in the second quarter of 1955 was about $28 billion above the first quarter of 1953, an increase of about 8 percent, one could hardly accuse the Federal Reserve of having moved vigorously in its restrictive credit policy.[8] Moreover, after the initial reduction in Government security holdings of the System open-market account in the first 2 months, open-market operations were so conducted as to produce no net change in Reserve bank holdings during the months of March through June. To be sure, failure to provide reserves through open-market operations may be regarded as a restrictive action. But in view of the swelling demands for credit, direct intervention of the System to reduce bank reserves would appear to have been more appropriate.

Apparently, the Open Market Committee counted on the stronger credit demands to drive the commercial banks to the discount windows of the Federal Reserve banks for their additional reserves. With the traditional reluctance of the banks to augment their indebtedness to the Federal Reserve and the rise in the discount rate in April, credit would be more costly and less available and thus undue credit expansion would be discouraged. However, the banks did not rush to borrow in any great amount from the Federal Reserve during the first half of the year. Between December 1954 and June 1955, bank borrowings from the Federal Reserve increased by less than $200 million. They relied on the disposal of their substantial holdings of Government securities, which they had accumulated under the influence of the easy money policy of 1953–54, to obtain funds to take care of the heavy demands for private credit. As we have seen, $5.7 billion of United States Government obligations were sold or redeemed during the first half of the year by all commercial banks.

[7] The following quotation from the First National City Bank Monthly Letter of May 1955, p. 53, is of interest: "* * * In light of the resurging strength of business, the only surprise was that the Federal Reserve had waited so long to act. As far back as January possibilities of a rate advance became a common topic of discussion. As it was, the Federal Reserve authorities limited their actions at that time to raising stock margin requirements and paring down idle loan funds among the banks while the Treasury reentered the long term market with an issue of 40-year 3-percent bonds. At the end of February, after the Treasury bond issue had been placed, talk of imminent action on discount rate spread about the financial community. The authorities contented themselves with suspending open market operations, permitting the business rise to carry forward on its established momentum, and letting the related credit demands absorb slack of excess reserves and compel banks to come in as borrowers from the Federal Reserve at the discount rate."

[8] As financial editor Edward H. Collins of the New York Times noted in his column of August 14, 1955: "There is at least a budding tendency to ask today * * * whether the Reserve, recalling the severe criticism towhich it was subjected (in 1953), isn't, consciously or unconsciously, proceeding somewhat overcautiously in this, its second bout with incipient inflation."

TABLE 32.—*Member bank reserves and related items, 1955–57*

[Averages of daily figures, millions of dollars]

Period	Federal Reserve credit	Gold stock	Currency in circulation	Total reserves	Required reserves
1955—January	25,449	21,714	30,110	19,114	18,432
February	25,021	21,715	29,784	18,819	18,195
March	24,989	21,718	29,790	18,635	18,050
April	25,070	21,680	29,807	18,800	18,210
May	24,924	21,673	29,861	18,746	18,166
June	24,958	21,676	30,050	18,715	18,146
July	25,497	21,680	30,284	18,825	18,205
August	25,450	21,682	30,289	18,728	18,152
September	25,525	21,682	30,420	18,711	18,148
October	25,792	21,685	30,532	18,870	18,345
November	26,089	21,687	30,791	18,902	18,378
December	26,853	21,689	31,265	19,240	18,646
1956—January	25,879	21,692	30,620	19,138	18,586
February	25,183	21,694	30,214	18,709	18,177
March	25,517	21,711	30,256	18,924	18,340
April	25,411	21,735	30,245	18,847	18,320
May	25,237	21,768	30,322	18,735	18,268
June	25,516	21,795	30,536	18,933	18,359
July	25,599	21,826	30,751	18,836	18,237
August	25,357	21,855	30,650	18,783	18,224
September	25,737	21,880	30,803	19,024	18,446
October	25,698	21,906	30,864	18,939	18,419
November	26,097	21,910	31,198	19,169	18,579
December	27,156	21,942	31,775	19,535	18,883
1957—January	25,905	21,989	31,040	19,295	18,773
February	24,912	22,279	30,595	18,816	18,302
March	24,968	22,305	30,568	18,884	18,366
April	25,411	22,313	30,614	19,087	18,580
May	25,041	22,358	30,645	18,827	18,362
June	25,189	22,621	30,902	18,982	18,485
July	25,466	22,625	31,116	19,129	18,595
August	25,166	22,626	31,035	18,834	18,300
September	25,489	22,627	31,143	18,956	18,434
October	25,326	22,660	31,109	19,040	18,573
November	25,373	22,743	31,335	18,958	18,447
December	26,186	22,769	31,932	19,420	18,843

Source: Board of Governors of the Federal Reserve System.

At its meeting of August 2, the Open Market Committee changed its directive from "maintaining conditions in the money market that would avoid the development of unsustainable expansion" to "restraining inflationary developments in the interest of sustainable economic growth." A few days later the Federal Reserve increased the discount rate from 1¾ to 2 percent.

Recent statements by top officials of the Federal Reserve with respect to the monetary policies pursued in 1954 and 1955 make it desirable to quote at length from the record of the August 2 meeting of the Open Market Committee indicating the basis for their decision to change their directive "to restraining inflationary developments":

> The shift to a policy of restraining inflationary developments resulted from the Committee's review of the economic situation and its conclusion that the supply of money and credit was a more stimulating force at the time than was desirable in the interest of sustainable economic growth. Information that had become available for June and July indicated that industrial production had increased to a new high level, with fairly general advances in durable and nondurable goods lines as well as in minerals. Unfilled orders had continued to rise. In addition, a renewed upsurge of consumer buying appeared to be developing. Buying of

TABLE 33.—*Member bank excess reserves, borrowings, and free reserves, 1955–57*

[Averages of daily figures, millions of dollars]

Period	Excess reserves	Borrowings at Federal Reserve banks	Free reserves
1955—January	682	313	369
February	625	354	271
March	585	463	122
April	590	495	95
May	580	368	212
June	569	401	168
July	619	527	92
August	577	765	−188
September	564	849	−285
October	524	884	−360
November	525	1,016	−491
December	594	839	−245
1956—January	552	807	−255
February	533	799	−266
March	585	993	−408
April	527	1,060	−533
May	467	971	−504
June	575	769	−194
July	599	738	−139
August	559	898	−339
September	579	792	−213
October	520	715	−195
November	590	744	−154
December	651	688	−37
1957—January	523	407	117
February	514	640	−126
March	518	834	−316
April	506	1,011	−505
May	465	909	−444
June	496	1,005	−508
July	534	917	−383
August	534	1,005	−471
September	522	988	−467
October	467	811	−344
November	512	804	−293
December	577	710	−133

Source: Board of Governors of the Federal Reserve System.

automobiles in July continued at record levels, and sales of appliances and other goods at department stores showed remarkable gains from the preceding month and a year ago. This upsurge in consumer demand reflected a further marked rise in consumer installment credit and an increased willingness of consumers to draw on liquid asset accumulations. It also suggested consumer expectations of higher prices later on. Numerous industries appeared to be producing at near capacity, and overall productivity gains had virtually disappeared in recent months. The situation was one in which a given percentage in output called for about an equal percentage gain in man-hours, and in which too easy access to bank credit was likely to result in increased prices rather than in increased production. There had been a substantial and contraseasonal rise in bank loans during the first half of the year, and in July all banking reports confirmed a continuing strong demand for bank credit.

The Committee believed that, with increased costs pushing upward on industrial prices, the general price level might well move upward with accompanying speculative increases in inventories. It also took into account discussions relating to a probable increase in the discount rate at the Federal

> Reserve banks early in August, based on observations of economic and financial developments in the respective Federal Reserve districts, and it agreed that the wording of its directive should be changed, as indicated above, to show that increased monetary restraint on credit expansion was now clearly appropriate.[9]

In view of the Committee's current and more or less similar appraisals since early May of the pace in economic activity, waiting 4 months before changing the discount rate and then raising it by only one-fourth of 1 percent was rather a feeble attempt at restrictive monetary action. By September there was greater realization within the Federal Reserve System that a larger increase was justified and the rate was advanced from 2 to 2¼ percent.

POLICY DECISIONS AS VIEWED IN RETROSPECT BY THE FEDERAL RESERVE

Officials of the System have recently admitted that they should have moved more vigorously, as the following statement by the presidents of the Federal Reserve banks indicates:[10]

> There is some question, however, whether the policy of ease was carried too far in 1954, when a combination of open-market operations and reductions in discount rates and reserve requirements pushed available reserves of member banks to high levels and short-term interest rates to exceedingly low levels. As noted above, commercial banks utilized a large portion of the available reserves to purchase Government and other securities. While this action cushioned the recession and provided a basis for recovery by promoting growth in the money supply, it also contributed to the growth of liquidity in the banking system. Consequently, when policy was shifted toward restraint in 1955, and gradually became more restrictive through 1955 and in 1956, commercial banks were in a position to meet demands of consumer and business borrowers by liquidating Governments and extending loan credit.
>
> *There also is some question whether the System moved fast enough in exercising restraint in the early and intermediate stages of the boom. Granted that a somewhat less easy policy in 1954 would have reduced commercial bank purchases of securities at that time, even the excessive liquidity existing at the beginning of 1955 might have been absorbed more quickly, and credit expansion thereby restrained further, had policy been tightened faster in 1955* * * * [Italic supplied.]

One reason given by the presidents of the Reserve banks for not moving more vigorously was that the economic data available in the first half of 1955 understated the speed of the recovery:[11]

> * * * The recovery from the recession of 1953–54 moved much faster than was generally expected; there were still doubts in early 1955 that the recovery was firmly established,

[9] Forty-second Annual Report of the Board of Governors of the Federal Reserve System, 1955, p. 102.
[10] Investigation of the Financial Condition of the United States: Joint and supplemental comments of the presidents of the Federal Reserve banks in response to the questionnaire of the Committee on Finance, U. S. Senate, 85th Cong., 2d sess., ch. 1, April 1958, p. 44.
[11] Ibid., p. 45.

> and there was considerable apprehension that a move toward tighter credit at a faster pace might halt the recovery short of its full potential. Much of the economic data available currently in the first two quarters of 1955 seriously understated the extent of the recovery up to that time. It was only later, when revisions of statistics became available, that the rapidity of the upturn became apparent. Moreover, it should be recalled that, at various times during the boom period, forces emerged that seemed to indicate a leveling off in business activity, or even an imminent decline. It is only through hindsight that the need for a more restrictive policy in the early stages of the boom seems clear.

Unfortunately, the Reserve Board presidents failed to indicate which of the many statistical series employed by their research departments in analyzing current business conditions misled them because they "seriously understated" the magnitude of the recovery. To be sure, there are limitations in currently published data that purport to reflect monthly and weekly changes in business conditions, and there is little doubt that Government officials would be greatly aided in arriving at sounder policy decisions if they were supplied with improved and more currently available statistical information. There were undoubtedly some statistical series, such as the quarterly estimates of the gross national product, that were revised upward after mid-1955, but understatement of these series during the first half of the year is hardly a justification for the implication that because of it monetary policy moved too slowly. There was an abundance of statistical information to indicate that the economy was moving upward at a rapid pace during the first 6 months of 1955, and that certain sectors were developing at a rate that could threaten economic stability. Apparently, the Open Market Committee was convinced by this evidence, since at the beginning of May it dropped the phrase "economic recovery" and its credit policy directive concentrated on "avoiding unsustainable expansion." By the summer of 1955, it was concerned with restraining inflationary developments. If the monetary authorities failed to act more vigorously, it was much more a matter of judgment and interpretation of the economic data than of the limitations inherent in the data. We must look in other directions for an explanation of the inadequacy of monetary policy in 1955. In this connection the following quotations from the testimony of Mr. Martin, Chairman of the Federal Reserve Board, before the Senate Finance Committee in August 1957, is of special interest: [12]

> Senator MARTIN. I would now like to ask you some questions about the present, current inflation. When did this current inflation begin?
>
> Mr. MARTIN. Well, I cannot state it precisely, Senator. It is pretty difficult to say that it began at any precise point.
>
> I think those of us in the System—and mind you, the System is not a one-man operation, for we have many varying views—I think we began to get worried about the current aspect of inflation in the middle of 1955. * * * Let me go back just a little bit if I may. In the inventory recession of 1953–54, we pursued a policy, and I think we were quite

[12] Investigation of the Financial Condition of the United States: Hearings before the Committee on Finance, U. S. Senate, 85th Cong., 1st sess., pt. 3, 1957, pp. 1304–1305.

correct in our policy, in the early stages, of adjusting promptly, to make the inventory adjustments as orderly as possible, by easing money.

By the end of 1953 and the early part of 1954, I personally think that we were overdoing it a bit. We were using the phrase "active ease."

One thing you find out about this is that while your weapons may be more effective in inducing restraint than they are in galvanizing the economy, nevertheless it is more difficult to get people to recognize the need for action when it comes to restraint.

And I think in retrospect that one of the errors we made was that, in 1954, when the adjustments that were being made by the market were culminating and the base was being laid for the recovery that we had, we got a little bit enthusiastic about increasing the money supply, and we lowered our discount rate in February 1954 from 2 to 1¾ percent; and then we lowered it again to 1½ percent in April of that year. * * *

The trouble in 1955, the place where I began to get concerned, was when it took us from April of 1954 until April of 1955 to move back from 1½ to 1¾ percent in the discount rate—a whole year—because the constant discussion in the System was, "Well, better not take a step, you had better not do anything to slow things down." You see, everybody likes expansion. Then we went up to 1¾. We later moved up successively during 1955 in four notches. * * *

Senator MARTIN. Do you feel you acted soon enough, and do you feel those actions were strong enough to stave off inflationary pressures then present?

Mr. MARTIN. No; I do not think we did. But there are differences of opinion on that within the System. *I would think we would have been more effective if we had acted a little bit quicker and a little bit sharper in our movements* * * *. [Italic supplied.]

Mr. Martin and the Federal Reserve bank presidents are in agreement that the System overdid the policy of credit ease in 1954, thus making it more difficult later for the monetary authorities to control credit expansion. However, the Chairman of the Federal Reserve Board, in accounting for the tardiness and lack of vigor of the restrictive actions taken in the upswing, stressed an important element ignored by the bank presidents. This is the human factor of hesitancy to exercise curbs when business expansion is underway. There is little doubt that the record of the past, as well as of the more recent period in monetary history, furnishes plenty of illustrations of the monetary authorities yielding to the weakness referred to by Mr. Martin. Since proper timing is of the essence of effective monetary policy, this limitation cannot be ignored in any evaluation of tools for promoting economic stability.

The tardiness and lack of vigor shown in 1955, however, was more than a matter of hesitancy by those responsible for decisions with respect to general credit policy to exercise restraints that might check the pace of business expansion. Part of the explanation may be found

in the theory of credit control that seemed to be influential among officials of the Federal Reserve System, as well as in the limitations of the tools that were actually employed.

THE DISCOUNT RATE AS A TOOL OF MONETARY RESTRAINT

All through the 1955–57 period, the discount rate was a major weapon employed by the Federal Reserve to limit bank credit expansion. The use of the discount mechanism is based on the view that member banks are traditionally reluctant to borrow funds from the Reserve banks or to remain in debt to them for any length of time. For the discount mechanism to act as a brake on credit expansion, it must be preceded by restrictive Federal Reserve open market operations that will put pressure on the reserves of the banks. From the degree of pressure exerted in 1955 it would seem that Federal Reserve officials were still under the influence of the theory propounded around the time of the accord that small changes in interest rates could have a significant influence on the decisions of lenders to curtail the expansion of private credit.[13] Since a substantial part of the portfolios of banking and financial institutions has come to consist of Government securities, these institutions are sensitive to small rises in interest rates and to the capital losses involved in disposing of Government securities in order to switch into private loans. This is a comfortable theory for those who have the responsibility for decisions with respect to flexible monetary policy. If one could be fairly successful in curbing excessive credit expansion without much of an increase in interest rates, one could avoid the unpopularity associated with such diverse criticisms as high interest rates result in sizable increases in interest payments by the Treasury on the large public debt, cause disturbances in the capital market through sharp fluctuations in capital values, enrich the banks through increased earnings, and have an adverse discriminatory effect on small businesses, homebuilders, and municipalities. Unfortunately, the view that a policy of monetary restraint which results in small rises in interest rates curbs credit through locking in securities of financial institutions received little support from the developments in 1955 and the first half of 1956.

The banks disposed of $5.7 billions of United States Government obligations during the first half of 1955, nearly $2 billion during the second half, and an additional $5 billion by the summer of 1956. Throughout this period interest rates were moving upward, and the rise was accompanied by the sale of more than $12 billion of both short-term and long-term securities in order for the banks to meet their credit demands. The discount rate was increased 6 times between April 1955 and August 1956—from 1½ percent to 3 percent. Bank loans increased $4.5 billion in the first 6 months of 1955, $7.4 billion in the second half of the year, and nearly $5 billion in the first 6 months of 1956.

Why did the view that small increases in the interest rate inhibit bank disposal of Government securities, thereby curbing bank credit expansion, not find support in the financial developments of 1955?[14]

[13] See Chapter I, p. 6.

[14] The theory might have had a more realistic basis if there had been effective consumer and mortgage credit controls in the first half of 1955.

One answer given by some critics of the theory is that it is based on a mistaken interpretation of the behavior of lending institutions during a period of rapidly increasing demand for loan funds. The anticipation of a rise in interest rates, instead of checking the disposal of securities because of fear of capital losses, acts for a considerable time to hasten such disposals. Even before the April change in the discount rate the banks sharply reduced their holdings of Government securities—a reduction of nearly $5 billion between January and March. They had been expecting a rise in the rate for some months, as was indicated on page 49. Such expectation increases the incentive to dump securities at a time when capital losses are minimal, and there appear to be ever-widening opportunities for profitable lending. The banks sold another $3 billion between April, the month of the first hike in the discount rate, and August, the month of the second hike.

Since their portfolios contained large quantities of short-term United States Government securities, the banks were prepared to take the relatively small losses from the sale of these securities and switch into more profitable areas such as mortgages, installment credit, and industrial and commercial loans. This was largely the case in 1955; later the banks sold mainly longer term Government securities on which they incurred heavier losses. After a time, to be sure, rising interest rates did have a noticeable influence in checking disposals. But it was not until mid-1956 that bank holdings of United States Government obligations stabilized and more or less continued at this level with relatively minor fluctuations through 1957. If for no other reason, a point is reached where considerations of bank liquidity cause the shifting out of Government securities to cease. In short, the Federal Reserve appeared to considerably underestimate the lag between the adoption of a policy of monetary restraint and the time when the policy takes effect.

Period	U. S. Government securities				Corporate bonds (Moody's)		Common stock yields, 200 stocks (Moody's)	High-grade municipal bonds (Standard & Poor's)	Average rate on short-term bank loans to business, selected cities	Prime commercial paper, 4 to 6 months	Federal Reserve bank discount rate
	3-month Treasury bills	9- to 12-month issues [1]	Taxable bonds								
			10 to 20 years [2]	20 years and over [3]	Aaa	Baa					
1955—January	1.257	1.36	2.66	2.77	2.93	3.45	4.22	2.39	----------	1.47	1.50
February	1.177	1.41	2.72	2.92	2.99	3.47	4.21	2.42	----------	1.68	1.50
March	1.335	1.49	2.72	2.92	3.02	3.48	4.21	2.45	3.54	1.69	1.50
April	1.620	1.71	2.77	2.92	3.01	3.49	4.12	2.43	----------	1.90	[4] 1.75
May	1.491	1.72	2.76	2.91	3.04	3.50	4.14	2.41	----------	2.00	1.75
June	1.432	1.71	2.77	2.91	3.05	3.51	3.87	2.48	3.56	2.00	1.75
July	1.622	1.88	2.88	2.96	3.06	3.52	3.78	2.62	----------	2.11	1.75
August	1.876	2.12	2.91	3.02	3.11	3.56	3.91	2.67	----------	2.33	[5] 2.00
September	2.086	2.14	2.88	3.00	3.13	3.59	3.93	2.63	3.77	2.54	[6] 2.25
October	2.259	2.19	2.82	2.96	3.10	3.59	4.12	2.56	----------	2.70	2.25
November	2.225	2.28	2.85	2.96	3.10	3.58	4.09	2.55	----------	2.81	[7] 2.50
December	2.564	2.56	2.88	2.97	3.15	3.62	4.06	2.71	3.93	2.99	2.50
1956—January	2.456	2.50	2.86	2.94	3.11	3.60	4.21	2.64	----------	3.00	2.50
February	2.372	2.38	2.82	2.93	3.08	3.58	4.09	2.58	----------	3.00	2.50
March	2.310	2.43	2.90	2.98	3.10	3.60	3.86	2.69	3.93	3.00	2.50
April	2.613	2.83	3.05	3.10	3.24	3.68	3.87	2.88	----------	3.14	[8] 2.75
May	2.650	2.83	2.94	3.03	3.28	3.73	4.13	2.86	----------	3.27	2.75
June	2.527	2.69	2.89	2.98	3.27	3.75	4.01	2.75	4.14	3.38	2.75
July	2.334	2.62	2.97	3.05	3.28	3.80	3.87	2.78	----------	3.27	2.75
August	2.606	3.01	3.15	3.19	3.43	3.93	4.02	2.94	----------	3.28	[9] 3.00
September	2.850	3.17	3.19	3.25	3.56	4.07	4.24	3.07	4.35	3.50	3.00
October	2.961	3.07	3.18	3.24	3.59	4.17	4.23	3.14	----------	3.63	3.00
November	3.000	3.15	3.30	3.30	3.69	4.24	4.25	3.38	----------	3.63	3.00
December	3.230	3.33	3.43	3.36	3.75	4.37	4.13	3.44	4.38	3.63	3.00
1957—January	3.210	3.17	3.33	3.34	3.77	4.49	4.31	3.40	----------	3.63	3.00
February	3.165	3.23	3.20	3.26	3.67	4.47	4.44	3.26	----------	3.63	3.00
March	3.140	3.35	3.25	3.27	3.66	4.47	4.35	3.32	4.38	3.63	3.00
April	3.113	3.41	3.30	3.35	3.67	4.44	4.16	3.33	----------	3.63	3.00
May	3.042	3.37	3.39	3.42	3.74	4.52	4.05	3.52	----------	3.63	3.00
June	3.316	3.55	3.61	3.54	3.91	4.63	4.05	3.75	4.40	3.79	3.00
July	3.165	3.71	3.63	3.58	3.99	4.73	4.01	3.75	----------	3.88	3.00
August	3.404	3.93	3.63	3.64	4.10	4.82	4.21	3.91	----------	3.98	[10] 3.50
September	3.578	4.02	3.72	3.61	4.12	4.93	4.50	3.90	4.83	4.00	3.50
October	3.591	3.94	3.84	3.63	4.10	4.99	4.68	3.79	----------	4.10	3.50
November	3.337	3.52	3.61	3.50	4.08	5.09	4.58	3.76	----------	4.07	[11] 3.00
December	3.102	3.09	3.28	3.33	3.81	5.03	4.77	3.47	4.85	3.81	3.00

[1] Includes certificates of indebtedness and selected note and bond issues.
[2] 2½ percent bonds, 15 years and over prior to April 1952 and 12 years and over beginning April 1952.
[3] 3¼ percent bonds of 1978–83, 1st issued May 1, 1953.

Sources: Board of Governors of Federal Reserve System, Treasury Department, Moody's Investor Service, and Standard and Poor's Corp.

EFFECTIVE DATES

[4] Apr. 15.
[5] Aug. 5.
[6] Sept. 9.
[7] Nov. 18.
[8] Apr. 13.
[9] Aug. 24.
[10] Aug. 23.
[11] Nov. 15.

THE DISCOUNT RATE AND CONSUMER CREDIT

The ineffectiveness of monetary policy in checking credit expansion was particularly evident in the case of consumer durable goods purchases, which played so important a role in the 1955 boom. The rise in interest rates neither inhibited the users nor the lenders of installment credit. The recent studies of installment credit prepared under the auspices of the Board of Governors of the Federal Reserve System indicate that users of consumer credit appear to be much more concerned with the amount of the downpayment and the maturity of the loan than with the interest rate.[15] They are frequently unaware of the actual financial rate they are being charged. The important consideration seems to be the amount of the monthly payments to be made. Under increasingly liberal financial arrangements, especially the lengthening of maturities, there was little change in the size of monthly payments during 1955.

Lending institutions were also not deterred by the interest rate from greatly expanding the volume of installment credit. Well over half of the $5.4 billion increase in installment credit during 1955 was supplied directly and indirectly by commercial banks. They were reluctant to curtail so profitable a source of earnings as consumer credit loans. They had become the largest supplier of installment credit so that by the end of 1955 they held 37 percent of the total outstanding installment loans. About 32 percent was held by sales finance companies with 4 of these companies doing three-fifths of the business. These large companies had little difficulty in obtaining funds either through borrowing from the banks at lower interest rates than were paid by all other bank borrowers, or direct placement of their commercial paper with nonfinance companies and large institutional investors, or through sale of their long-term notes and debentures.

[15] Consumer Instalment Credit: A study by the Board of Governors of the Federal Reserve System, 6 vols. 1957. Pt. I: Growth and Import, 2 vols. Pt. II: Conference on Regulation, prepared under the auspices of the National Bureau of Economic Research, 2 vols. Pt. III: Views on Regulation, 1 vol. Pt. IV: Financing New Car Purchases, a national survey for 1954–55, 1 vol.

TABLE 35.—*Installment credit, 1955–57*

[Millions of dollars]

End of month	Total outstanding	Automobile paper [1]	Other consumer goods paper [1]	Repair and modernization loans [2]	Personal loans
1955—January	23,512	9,861	6,668	1,574	5,409
February	23,604	10,028	6,563	1,552	5,461
March	24,046	10,410	6,554	1,533	5,549
April	24,591	10,796	6,596	1,538	5,661
May	25,204	11,254	6,665	1,552	5,733
June	25,969	11,794	6,770	1,572	5,833
July	26,509	12,235	6,810	1,585	5,879
August	27,154	12,718	6,888	1,612	5,936
September	27,653	13,075	6,962	1,639	5,977
October	27,913	13,246	7,029	1,664	5,974
November	28,211	13,327	7,176	1,678	6,030
December	28,958	13,472	7,634	1,689	6,163
1956—January	28,849	13,488	7,517	1,662	6,182
February	28,896	13,582	7,429	1,656	6,229
March	29,101	13,750	7,376	1,662	6,313
April	29,424	13,898	7,434	1,680	6,412
May	29,779	14,065	7,578	1,718	6,478
June	30,114	14,261	7,554	1,748	6,551
July	30,366	14,389	7,590	1,768	6,619
August	30,743	14,539	7,697	1,799	6,708
September	30,841	14,547	7,733	1,832	6,729
October	30,985	14,498	7,872	1,865	6,750
November	31,240	14,469	8,066	1,890	6,815
December	31,827	14,459	8,510	1,895	6,963
1957—January	31,568	14,410	8,305	1,872	6,981
February	31,488	14,432	8,160	1,859	7,037
March	31,524	14,528	8,043	1,856	7,097
April	31,786	14,691	8,017	1,862	7,216
May	32,158	14,883	8,081	1,886	7,308
June	32,608	15,127	8,165	1,905	7,411
July	32,968	15,329	8,189	1,921	7,529
August	33,303	15,490	8,229	1,954	7,630
September	33,415	15,556	8,228	1,969	7,662
October	33,504	15,579	8,236	1,988	7,701
November	33,596	15,542	8,300	1,996	7,758
December	34,105	15,496	8,687	1,984	7,938

[1] Represents all consumer installment credit extended for the purpose of purchasing automobiles and other consumer goods, whether held by retail outlets or financial institutions. Includes credit on purchases by individuals of automobiles or other consumer goods that may be used in part for business.

[2] Represents repair and modernization loans held by financial institutions; holdings of retail outlets are included in other consumer goods paper.

Source: Board of Governors of the Federal Reserve System.

We have seen that concern was expressed about consumer credit expansion during almost every one of the 1955 meetings of the Open Market Committee. But the Federal Reserve had no authority to exercise selective controls over downpayments and maturities with which to curb excessive expansion of consumer credit. It had such powers under temporary authority during 1941–47, 1948–49, and in 1950–52. Nor did it request the Congress for authority to regulate consumer credit at any time since the expiration of regulation W in mid-1952.

The January 1956 Economic Report of the President had pointed out that installment credit accentuates swings in consumer durable goods purchases, "thereby exposing the rest of the economy to the hazard of widened fluctuations." [16] The report appeared to regard favorably standby controls over installment credit as a supplementary stabilization device and recommended study of the problem: [17]

> * * * Experience during the recent past suggests that the authority to set, if and as circumstances may require, mini-

[16] Economic Report of the President, January 1956, p. 94.

[17] Ibid., p. 94.

mum downpayments and maximum maturities on installment credit for the purchase of consumer durables would be a useful adjunct to other stabilizing measures. Its availability as a standby measure, to be used only when the economic situation demands it and under proper administrative safeguards, would increase the Government's ability to fulfill its responsibilities under the Employment Act. Although present conditions do not call for the use of such authority to regulate the terms of installment credit, this is a good time for the Congress and the executive branch to study the problem. * * *

About the time of the release of the President's report, Mr. Martin, Chairman of the Federal Reserve Board, was appearing before the Senate Banking Committee which was concerned with his nomination for a full term of 14 years. During 2 days of hearings he was questioned at length about the monetary policies pursued by the Federal Reserve during the preceding year and on the influence of the Treasury on the Board's actions. Mr. Fulbright, chairman of the committee, closed the hearings by reading a statement on consumer credit which indicated his readiness to schedule hearings on the question of granting standby authority. The statement in part read as follows: [18]

I have been greatly concerned about the tremendous growth of consumer credit for some time now. During the stock-market hearings last year, I and other members of this committee called attention to the potential dangers in the marked rise of installment credit. The President's economic report states that in the second quarter of 1955 consumer installment debt expanded by nearly $2 billion, the largest on record over so brief a period. While members of the Committee on Banking and Currency cautioned the public on the dangers of excessive credit in this area, as well as in the stock market, the administration's concern seems belated. * * *

If the administration wants standby authority over consumer credit, I shall be glad to schedule hearings on their proposal. The staff of the committee has been gathering data and opinions on this subject for some time.

Generally, I prefer indirect credit regulations to direct controls, but the indirect methods did not stop an unhealthy increase in consumer credit last year. Whether this was because general credit instrumentalities were not effectively employed or whether they were simply inadequate, I am not prepared right now to say. If consumer credit controls had been in existence in 1955, prospects for consumer durable goods this year might well be brighter. It now appears that a great part of the boom of 1955 was borrowed from the future, in the form of great increases in private debt for consumer durables.

In any event, however, we should not permit a recurrence of excessive borrowing which can only result in violent fluctuations in so important an industry as automobiles.

[18] Nomination of William McChesney Martin, Jr.: Hearings before the Committee on Banking and Currency, U. S. Senate, 84th Cong., 2d sess., January 20 and 27, 1956, pp. 68–69.

Insofar as the 1955 prosperity was based on an unusually rapid expansion of consumer debt, there is a real question whether the high level of activity was not achieved at the expense of substantially lower levels of production in 1956.

THE SHIFT IN FEDERAL RESERVE ATTITUDE TOWARD CONSUMER CREDIT CONTROLS

In mid-February 1956 the President, through the Council of Economic Advisers, requested the Board of Governors of the Federal Reserve System to undertake "a broad study of the role of consumer installment credit in a growing economy, including arguments for and against renewal in some form of governmental authority to regulate credit, in this field." This 6-volume, 2,000-page study, which was published by the Board in the spring of 1957, contains a vast mass of factual and analytical materials pertaining to consumer installment credit, and widely varying viewpoints are represented on the question of regulation of consumer credit.

On May 24, 1957, the Board of Governors, after studying these reports, transmitted a two-page statement to the chairmen of the Senate and House Banking and Currency Committees, the Joint Economic Committee, and the Council of Economic Advisers, giving its views on the regulation of consumer installment credit.[19] The principal conclusion of the Board of Governors was that—

> *a special peacetime authority to regulate consumer installment credit is not now advisable. The Board feels that the broad public interest is better served if potentially unstabilizing credit developments are restrained by the use of general monetary measures and the application of sound public and private fiscal policies.*[20] [Italic supplied.]

It is of interest to record the third, fourth, sixth, and eighth findings of the Board: [21]

> (3) Though of recognizable importance as a factor of instability, fluctuations in consumer installment credit have been generally within limits that could be tolerated in a rapidly growing and dynamic economy.
>
> (4) A possible exception to the third finding occurred during the 1954–56 upswing in economic activity. The rapid expansion of consumer installment credit in 1955, with its accompanying secondary impacts on capital investment, contributed to the emergence of inflationary pressures. This expansion, however, combined with real estate mortgage and other types of credit expansion in producing this sequence of developments.
>
> (6) Liberalization of installment credit terms and standards from mid-1954 through 1955, which was particularly marked in connection with the purchase of new automobiles, contributed to the further widening of the practice of installment buying and borrowing and to the very great expansion in installment credit outstanding that occurred. Some of the

[19] Federal Reserve Bulletin, June 1957, pp. 647–648.
[20] Ibid., p. 648.
[21] Ibid., p. 648.

forces making for this rapid widening of the market for consumer credit were temporary. Also, this drastic liberalization of credit terms and standards exposed consumer lenders to increased risks. On both counts, the forces making for credit liberalization in that period were to an extent transient and self-limiting.

(8) Under peacetime conditions, special regulation of consumer installment credit would inevitably present problems of compliance to the financing and business firms subject to it, and of administration and enforcement to the agency of Government responsible for the regulation.

It is important to note that the Board of Governors had expressed itself with much greater vigor on the contribution of consumer credit to economic instability 5 years earlier in a more comprehensive statement on the subject submitted for the Patman committee report.[22] The Board had also regarded selective regulation of this area as a helpful supplement to general monetary controls. Let us quote from the earlier Federal Reserve statement:

> Expansion in consumer credit adds directly to the growth of bank credit and by this means to the money supply. A substantial part of the consumer credit outstanding is financed either directly or indirectly by bank loans. In addition to the consumer loans made directly by banks, a large part of the funds of sales finance and personal loan companies is obtained from bank sources, and a great many retail establishments finance their receivables partly through borrowing at banks. Thus, a substantial part of every dollar of additional consumer credit ordinarily stems from bank credit expansion and represents a direct addition to the total number of dollars competing for an existing supply of goods and services. To the extent that nonbank lenders sell Government securities to finance an expansion of their consumer credit balances, this also affects the money supply directly or indirectly. Of equal importance from the standpoint of monetary stability is the fact that the operations of bank and nonbank lenders in this credit area influence the activity or turnover of money. An expansion of consumer credit, accordingly, affects both the money supply and its circulation.[23]
>
> The general role of consumer installment credit in economic fluctuations can be described briefly as follows: When incomes rise in the upswing of the cycle, demand for and extensions of installment credit increase, with the result that the expenditures of people increase more rapidly than their income. When incomes shrink in the downswing of the economic cycle, demand for and extension of credit decreases and outstanding installment balances contract. In order to pay off debt, people are forced to cut back their expenditures more than if they had not incurred debts in the upswing. This

[22] Monetary Policy and the Management of the Public Debt: Their Role in Achieving Price Stability and High-Level Employment: Replies to questions and other material for the use of the Subcommittee on General Credit Control and Debt Management, Joint Committee on the Economic Report, 82d Cong., 2d sess., 1952, pt. I, pp. 410–418.

[23] Ibid., pp. 411–412.

expansion and contraction of consumer debt * * * is a significant factor in fluctuations in bank credit and the money supply.

The generalization to which this description leads is that fluctuations in installment credit accentuate cyclical swings in consumer expenditure and hence in economic activity. This cause and effect role of consumer credit in economic fluctuations is in many respects similar, of course, to that of other credit, producer credit included, but, as pointed out later, continued expansion of consumer credit in periods of strong inflationary boom has a significance somewhat different from that of producer credit. * * *[24]

Consumer credit functions at a point in the economy and in a manner that tends to make it relatively unresponsive to the effects of general credit instruments. For this reason selection of this credit area for regulation provides a helpful supplement to the general measures * * *[25] [Italic supplied.]

Thus, the unregulated expansion of consumer credit adds to general inflationary pressures and might actually require a more aggressive use of general credit instruments than would otherwise be necessary. That is to say, in the absence of selective regulation of consumer credit, other means of credit restraint might have to be exercised more restrictively in order to bring about sufficient restraint on the overall expansion of private credit. This emphasizes the desirability of being able to use selective credit measures to complement, but not to substitute for, overall or general credit measures, the extent of such use depending on prevailing economic circumstances. One of the primary justifications for the selective regulation of consumer credit is that it helps to avoid too strong effects on segments of the economy that are more sensitive to general credit actions.[26]

It should be noted that there was at least one top official of the Federal Reserve System who spoke out vigorously in 1955 for giving the System authority over installment credit. Mr. Allan Sproul, president of the Federal Reserve Bank of New York, in an important address before a joint meeting of the American Finance Association and the American Economic Association in December 1955, declared:[27]

* * * I know that there are those who believe that selective credit controls are a dangerous step on the road to general overall planning, and I have no desire to become a fellow traveler on that road. But I do believe that there is a temptation to abuse consumer credit in boom times, that it

[24] Op. cit., pp. 411–413.
[25] Op. cit., p. 413.
[26] Op. cit., p. 414.
[27] Allan Sproul, Reflections of a Central Banker, Journal of Finance, March 1956, p. 12. This address also challenged economists to take the lead in assisting monetary authorities to reexamine the basic problems in the field of central banking. He stressed the necessity of independent analysis of these problems by persons not connected in any official capacity with the System. His remarks in this connection were as follows:

"We have excellent research staffs in the Federal Reserve System: able economists and statisticians and devoted students of money and banking problems. But their work needs more cross-fertilization and critical analysis by thoughtful and disciplined minds outside the System who can apply their talents to this special field without the bias of an organizational viewpoint. Not enough work has been done, I would say, on the monetary problems of a mixed Government-private economy, on the functioning and form of a fractional reserve banking system in such an economy, on the growing importance of other financial institutions, which crisscross both the fields of commercial banking and investment banking, and on the performance and characteristics of our money and capital markets. These are subjects which are becoming critical in the development of central banking * * *" (pp. 13–14).

can thus become a serious source of instability in our economy, and that we would not jeopardize our general freedom from direct controls by giving the Federal Reserve System permanent authority to regulate consumer credit. * * *

MONETARY POLICY AND THE GROWTH OF FINANCIAL INTERMEDIARIES

We have seen that the ineffectiveness of monetary policy resulted in part from a reluctance to move vigorously to restrict credit when business confidence was high and activity was rapidly expanding. Apart from the limitation of this human factor, the nature of the boom was such that areas which were making the greatest demands on credit in 1955—housing and consumer durables—were those that were not particularly sensitive to the restrictive tools actually employed by the Federal Reserve.

There is an additional limitation on monetary policy which has been stressed in recent years, namely, the greatly changed institutional and financial environment in which the banking system operates. In particular, what is referred to is the vastly increased importance of the role played by financial intermediaries, such as life insurance companies, building and loan associations, savings banks, investment companies, and pension funds, in the field of credit. Since World War II the increase in the assets of nonbank financial intermediaries was at least three times that of commercial banks. The acceleration in the flow of savings to nonbank financial institutions raises many problems with respect to the functioning of our capital markets. Here we are concerned, however, only with the contention that the growth of these institutions has rendered monetary policy less effective in restricting credit during the recent boom.

Life insurance companies, savings and loan associations, and mutual savings banks invested heavily in mortgages in 1955. During the year these 3 groups acquired over two-thirds of the more than $16 billion increase in the nonfarm mortgage debt. Life insurance companies and savings banks not only financed mortgages through savings that were channeled to them, but also obtained additional funds for such loans by borrowing heavily from the commercial banks. Under "warehousing" arrangements they either sold mortgages to the banks which they agreed to buy back or they obtained forward commitments from the banks in order to make good on their own forward commitments to lend. Savings and loan associations expanded their mortgage activity by greatly increasing their borrowing from the Federal home-loan banks.

From one point of view, it would seem that the growth of financial intermediaries should have made the capital markets more sensitive to a restrictive monetary policy. These institutions hold a considerable proportion of the public debt. Since their portfolios contain the longer term Government securities they should be especially sensitive to capital losses arising from increasing interest rates. Critics of general monetary controls, however, have argued that the financial intermediaries have reduced the effectiveness of Federal Reserve policy. Their spectacular growth has signified greater efficiency in assembling idle funds and putting them to work. In a period when monetary policy seeks to restrict the money supply, these institutions

increase the velocity of monetary circulation by increasing the proportion of the money supply that is actively spent at the expense of the portion that is held idle. By selling their Government securities to nonbank investors they take—

> up idle balances which they transfer to active spenders by making mortgage or other loans or by buying newly issued corporate securities. In this case idle balances become active, passing through financial institutions in the process, and velocity is increased.[28]

The critics have argued that the monetary authorities have placed excessive emphasis on the money supply and on the volume of bank reserves and have not given sufficient attention to the change in the velocity of money.[29]

In the minds of some students of Federal Reserve policy, the growth of financial institutions raises the question whether, in the interest of promoting economic stability, it is not desirable to supplement general monetary controls with selective control over housing credit as well as over installment credit.[30]

THE TIGHT MONEY POLICY AND ITS CRITICS, 1956 TO MID-1957

Once the monetary authorities failed to adopt stronger measures in 1955, they were in the proverbial position during the following year and a half of holding a bear by the tail. The great increase of consumer and mortgage credit which stimulated the production of nearly 8 million cars and the construction of more than 1.3 million homes in 1955 sparked the expansion of plant and equipment expenditures. These expenditures rose 7 percent in 1955, and in 1956 they advanced to record levels with a 22-percent rise over the preceding year. The increasing pressure on resources and manpower culminated in an upward movement of wholesale industrial prices starting in mid-1955. By the end of 1956 these prices rose 8 percent. During the year the index of industrial production, however, hovered more or less around the advanced level reached in December 1955. Despite a 16-percent decline in housing starts and more than a 20-percent drop in production of automobiles in 1956, the sharp rise in plant and equipment expenditures was a major factor in the continuation of the high level of business activity. The rate of economic expansion slackened with about one-half of the advance in the gross national product accounted for by higher prices.

The monetary authorities had a difficult course to steer with respect to credit policy in 1956. On the one hand, there was the risk that a more liberal policy with respect to the availability of bank reserves might accelerate price rises, especially in "bottleneck" sectors of the economy. In these sectors production could not readily advance, or if output were expanded it would be at substantially higher costs. On the other hand, if the policy became much more restrictive, there was the danger of initiating a downward spiral in business activity since certain of the key sectors which had ushered in the boom had been showing considerable weakness for some time.

[28] Warren L. Smith, On the Effectiveness of Monetary Policy, American Economic Review, September 1956, p. 602.
[29] Ibid., pp. 600–604. On the influence of the growth of financial intermediaries see also: Arthur F. Burns, Prosperity Without Inflation, Fordham Universty Press, 1957, ch. 3.
[30] See Irwin Miller, Monetary Policy in a Changing World, Quarterly Journal of Economics, February 1956, p. 34ff; Alvin H. Hansen, The American Economy, McGraw-Hill, 1957, ch. 3.

The Open Market Committee directives during 1956 reflected the uncertainties resulting from the mixed trends of the various sectors of the economy. From late January to late March, the credit policy directive read that transactions in the System open market account were to be with a view "to restraining inflationary developments in the interest of sustainable economic growth" but should also take "into account any deflationary tendencies in the economy." This supplementary clause "gave consideration to the view that the domestic economy after a year and a half of expansion might be nearing a cyclical peak and that a reaction might be in prospect before long." [31]

At the end of March, however, the clause to take into account deflationary tendencies was deleted, since the balance of evidence was believed to indicate a further advance in the economy. The record stated: [32]

> * * * Among the general factors leading to this conclusion were the much greater than expected plans of business concerns in all major lines for plant and equipment expenditures, the widespread optimism of consumers as to the economic outlook and their own financial position and income prospects, and evidence of an exceptionally heavy demand for bank credit in the current month. The committee also noted that common stock prices had risen sharply further. Growing pressures for increases in prices and wages were evident, and there was danger that if supported by further credit expansion pressures would engender an inflationary spiral. * * *

Consideration was also given to possible action by the Federal Reserve to increase the discount rate to "prevent undue credit expansion for financing capital outlays through the banking system." [33] In April the Board of Governors raised the discount rate from 2½ percent to 2¾ percent in 10 of the Reserve banks and to 3 percent for the 2 others. By the end of May, however, the directive once more added the additional clause of taking into account deflationary tendencies as well as pursuing a policy of restraining inflationary developments. This directive was continued until early in August. In this month the Board of Governors raised the discount rate from 2¾ to 3 percent. For the remainder of the year the directives called for restraining inflationary developments in the interest of sustainable economic growth. During the last month, there was a supplementary clause that "recognition should be given to additional pressures in the money, credit, and capital markets resulting from seasonal factors and international conditions." [34]

With the economy continuing to operate near capacity levels—despite some uncertainties about its general direction during the first part of the year—and with prices and wage rates moving upward, the Open Market Committee felt that as a general policy it could not relax in its efforts at restricting the availability of bank reserves. Despite mounting criticism of the "tight money policy"—what with interest rates advancing in all sectors of the money and capital markets

[31] Forty-third Annual Report of the Board of Governors of the Federal Reserve System, 1956, p. 20.
[32] Ibid., p. 26.
[33] Op. cit., p. 27.
[34] Op. cit., p. 43.

and especially long-term rates because of the increased business demand for investment funds—the determination of the Federal Reserve to resist pressures for relaxation during 1956 and the first half of 1957 was applauded in many quarters. Open market operations were so conducted that the security holdings of the System had increased by only $160 million during 1956. The money supply had risen by $1.5 billion, representing a rate of increase of only 1 percent, as compared to a 2.8 percent rise in 1955. However, the rate of turnover of demand deposits in centers outside of New York City increased 8 percent in 1956.

To be sure, there was also increasing criticism that while business firms were able to obtain funds for capital expansion from the banks and through the security markets—over 70 percent of the $7.6 billion increase in bank loans in 1956 was in the category of business loans—residential builders, small business firms, and State and local governments were adversely affected by the restrictive monetary policy. Other critics pointed out that neither open-market operations nor further rises in the discount rate accomplished the objective of the restrictive credit policy since plant and equipment expenditures—the major influence in the intensification of inflationary pressures—were not inhibited from continuing their rapid rise throughout 1956. During the year more than four-fifths of corporate outlays for plant and equipment was derived from depreciation and amortization allowances and retained profits. Toward the first of these criticisms, officials of the Federal Reserve took the position that in a free economy the market was the regulator of the flow of credit and not the monetary authorities.[35] With respect to the second criticism, the Federal Reserve recognized that liberal depreciation and amortization provisions in the tax law and large corporate earnings contributed to the capital boom, but it was pointed out that were it not for its restrictive policy, capital expenditures would have been greater and inflationary pressures in other areas would have been intensified.[36] In support of this position they cited the large volume of scheduled offerings in the capital market that were canceled or postponed.

DELIBERATIONS OF THE OPEN MARKET COMMITTEE IN 1957

One may justifiably view with favor the determination of the monetary authorities not to relax restraints in 1956 and in the first half of 1957, but there is much less justification for regarding favorably the policies pursued through the summer and fall of 1957. As critics have pointed out, in holding onto a policy of restraint too long, the Federal Reserve may have contributed to accelerating the pace of the downswing in business activity. The monetary authorities had become so preoccupied with the increase in inflationary pressures since mid-1955 that they ignored the cumulative evidence which pointed to the likelihood of the boom ending in the not-too-distant future. At least so it seemed from the public statements by Federal Reserve officials, their testimony at congressional hearings, and policy decisions such as raising the discount rate one-half percentage point, i. e., to 3½ percent, in August. At his appearance before the Senate Finance

[35] Hearings on January 1957 Economic Report of the President, Joint Economic Committee, U. S. Congress, 85th Cong., 1st sess., 1957, p. 591.
[36] Investigation of the Financial Condition of the United States: Hearings before the Committee on Finance, U. S. Senate, 85th Cong., 1st sess., pt. 3, August 1957, p. 1399.

Committee during that month, the Chairman of the Federal Reserve Board stated that credit restraint is "required at present, for clearly the most critical economic problem now facing the country is that of inflation." [37] In the fall and almost up to mid-November, when the discount rate was lowered from 3½ to 3 percent giving public notice that the Federal Reserve regarded the immediate problem ahead as not inflation but business contraction, presidents of the Reserve banks and members of the Board of Governors of the System were making speeches that inflation was still the No. 1 economic problem and it would be a great mistake to relax credit restraint.

In the light of the vehemence and the frequency with which Federal Reserve officials publicly stressed during the first 10 months of 1957 the necessity for continuing monetary restraint, it comes as a surprise to read the record of the 1957 meetings of the Open Market Committee published in the annual report of the Board of Governors and released in April 1958. During almost all of the 18 meetings held throughout the year there appeared to be an absence of that confidence in the continuation of the upward movement of business activity and in the intensification of inflationary pressures which was manifested in public statements by top spokesmen for the System. Even as early as January the record indicates:[38]

> There were * * * developments that suggested that the economy might be losing some of its upward momentum. While these data were not sufficient to support a forecast of a downward turn as a clear, nearby prospect, they suggested that the economy might be entering a period of sidewise movement. For example, a tendency for total capital expenditures to level off was evidenced by recent figures for factory construction contracts, new machine tool orders, and freight car orders, together with scattered announcements of postponements of plant construction projects. There were cross currents in the area of prices with higher costs showing up in increased prices for finished goods, both at wholesale and at retail, in contrast with a softening trend in prices of a number of primary products. Business loans at all reporting member banks after a fourth quarter rise of $1.6 billion declined by more than $700 million in the 3 weeks to mid-January, a postwar record decline for the period that compared with a drop of $355 million a year earlier. A rapid decline in security loans had also occurred and about three-fourths of the total rise in loans during the fourth quarter of 1956 had been wiped out. * * *

In February it was noted that there was some easing of inflationary pressures.

> It was too early to tell, however, whether this was but a temporary lull, the beginning of a downturn, or the attainment of high-level stability.

During the first 2 months of the year there was no change in the credit policy directive that open-market operations were to be conducted with a view—

[37] Investigation of the Financial Condition of the United States: Hearings before the Committee on Finance, U. S. Senate, 85th Cong., 1st sess., pt. 3, August 1957, p. 1262.
[38] Forty-fourth Annual Report of the Board of Governors of the Federal Reserve System, 1957, p. 37.

> to restraining inflationary developments in the interest of sustainable economic growth, while recognizing unsettled conditions in the money, credit, and capital markets and in the international situation.

At the beginning of March, the wording was changed. While calling for a continuation of restraint on inflationary developments, the directive took recognition of "uncertainty in the business outlook, the financial markets, and the international situation."

> This change in wording * * * was not an indication of a shift in direction of policy but was designed to emphasize the factor of uncertainty in the current business outlook. The general direction of policy continued to be one of restraining inflationary developments.
>
> In its review of conditions, the committee found evidence of the slowing down of expansionary forces in many sectors of the private economy but no indication that a pronounced downturn had begun. Rather, there were many underlying forces tending to hold activity at a high level. * * * [39]
>
> While it was apparent that a sidewise movement was taking place in the economy, there was uncertainty as to which way the economy would go. In any event, however, since the economy's upward momentum had definitely slackened and since the rise in finished goods prices seemed likely to level off in the near future, it was not believed appropriate that overt action be taken toward increasing credit restraint, although maintenance of about the degree of restraint that had existed for some time seemed to be called for. * * * [40]

The March policy directive of the Open Market Committee was renewed without change at each of its subsequent meetings until the revision of November 12.

Around mid-year and during the month of August when the discount rate was raised from 3 to 3½ percent, the Open Market Committee continued to note that business activity manifested a sidewise movement and that divergent trends in various sectors "provided no clue as to the direction and intensity of the next major change in economic activity." [41] The increase of one-half percentage point in discount rates "was regarded as primarily a technical move made at a time when market interest rates were considerably above discount rates".[42] The Board of Governors of the Federal Reserve System, at its August 8 meeting approving the relatively large hike in the discount rate, also noted the general sidewise movement of the economy but stressed the upward trend of prices and wages and the vigorous demand for credit which was pushing interest rates upward: [43]

> * * * With the upward movement of interest rates, the discount rate of the Federal Reserve banks, which had stood at 3 percent since the fall of 1956, fell further behind the rate structure generally. The disparity became even more pronounced in early August when the commercial banks in-

[39] Ibid., p. 42.
[40] Ibid., p. 43.
[41] Ibid., p. 49.
[42] Ibid., p. 50.
[43] Ibid., p. 68.

> creased from 4 to 4½ percent the rate charged on loans to prime business borrowers.
>
> The increase in the Federal Reserve bank discount rates, which brought them into better alinement with money market rates, raised the cost to member banks of operating on borrowed reserves and thus diminished incentive on the part of the member banks to borrow from the Reserve banks.

At the September 10 meeting, the Open Market Committee found no material change in business activity for the past several months. It was noted that bank credit had expanded less rapidly in the previous 5 weeks than in other recent years and some slackening in money turnover had appeared. On October 1 the Committee took note of the fact that—

> an increasing number of business observers were suggesting that the major expansive forces had been spent, that pressure of inflationary forces was in process of lessening and even of dispersing, and that the prospective movement in activity was a decline. Business sentiment * * * appeared to be developing into a psychology of gloom in some places and was much more cautious about prospects than for some months * * * On the other hand, the reports to the Committee at this meeting did not present a picture of a settling or declining economy. There was considerable feeling that while inflationary clouds might be breaking up, it would be premature to conclude that they had been scattered. * * *[44]

On October 22, 3 weeks before the Federal Reserve had signaled a definite shift in its position through the reduction of the discount rate from 3½ to 3 percent, the Open Market Committee still appeared uncertain as to how the economy would[45]

> * * * breakout from the sidewise movement that had been characteristic of business for some months. In a searching reexamination of the economic situation, the Committee found that the latest quarterly and monthly figures showed continuation through the third quarter of 1957 of many features prevailing earlier in the year, with production steady at a high level, price movements in wholesale markets mixed with the average up, and consumer prices generally continuing upward. September industrial production was at 144, down a point from August but within the narrow 143 to 146 range prevailing so far this year. The economy as a whole showed basic strength, but there was uncertainty as to what combination of demands would prevent recession in activity, or, on the other hand, make for an advance in total output and employment from present levels.
>
> In analyzing the implications of recent business and credit developments for monetary and fiscal policy, it appeared that there had been short-run abatement in inflationary pressures, and questions were raised about potential declines in important sectors of activity. Business sentiment had turned more pessimistic than the current indicator picture, and attitudes of common stock investors appeared to reflect

[44] Ibid., pp. 51-52.
[45] Ibid., pp. 53-54.

> a growing disbelief in the extension of inflationary trends. Business loan expansion was continuing to run behind the preceding year. As a result of the increasing uncertainty as to the business situation * * * the environment for monetary policy was beginning to look quite different from the boom conditions that initially justified the current restrictive policy. * * *
>
> The Committee concluded, after reviewing the data, that there was no immediate occasion to reverse its policy of restraint in credit expansion or to make a change in the policy directive. While it was clear that the Committee at this juncture did not wish to make any move which would signal a change in policy, it wished to supply seasonal needs reasonably freely. It did not wish to increase restraint from what it had been. There was some feeling that the Committee should actually diminish restraint a little, but more of the members believed that the Committee should resolve doubts on the side of ease. Thus, in renewing the directive without change, the Committee agreed that although general policy was not to be changed appreciably, it should tend on the easier side from where it had been in recent weeks.

On November 12 the Open Market Committee decided "that action should now be taken to recognize the change in the general economic situation away from the sidewise movement that had prevailed during most of 1957." It had finally become convinced that a business recession was underway:[46]

> * * * there was no longer much doubt that at least a mild downturn in business activity was underway, and there was widespread belief that it would probably continue well into 1958. The major question seemed to be not whether a further business decline would occur, but for how long and in what degree. In terms of credit policy, the question presented was how far the Committee should go at this time in recognizing the change in the economic situation and outlook, and by what means. * * *

Its policy directive was changed from that of restraining inflationary developments to "fostering sustainable growth in the economy without inflation, by moderating the pressures on bank reserves." Two days after this revision, the Board of Governors of the System approved the reduction of the discount rate to 3 percent, with one member (Mr. Robertson) dissenting on the ground that the "economic situation did not call for an overt act that could be interpreted as a drastic move toward monetary ease."[47] In mid-December the Open Market Committee revised its credit policy directive to provide that open-market operations were to be conducted with a view "to cushioning adjustments and mitigating recessionary tendencies in the economy."[48]

> The economic and financial data presented at this meeting confirmed rather clearly the developing recession that had been indicated by reports at earlier meetings at which the Committee acted to moderate the pressures on bank re-

[46] Ibid., p. 56.
[47] Ibid., p. 70.
[48] Ibid., p. 61.

serves. The recession was still of moderate intensity, and inasmuch as the Committee actions taken since mid-November to lessen pressures on reserves, together with the reduction in Reserve bank discount rates, had signaled an effective change in policy toward less severe credit restraint, it did not appear to the Committee that additional major actions were necessary at the moment. The change at this meeting in wording of the Committee's policy directive was adopted with the understanding that reserves would continue to be made somewhat more available, but the particular reason for this change was to recognize that the economy had encountered a recession and that the Federal Open Market Committee's policies were being molded accordingly. * * *

THE MISTAKEN CREDIT POLICIES AFTER MID-1957

In defending the tight monetary policies of 1956 and 1957 before congressional committees, Government officials frequently quoted in support of their actions from the 1950 report of the Douglas Subcommittee on Monetary, Credit, and Fiscal Policies. But they generally failed to refer to those sections of the report which stressed that to be effective, monetary management must be characterized by timely, vigorous, and flexible actions. We have seen that officials of the Federal Reserve System stated in retrospect that they fell short of satisfying these criteria in 1955. Although they have not yet admitted to shortcomings in the application of these criteria in the second half of 1957, it is not unlikely that, after allowance of a longer period for hindsight, the violation in the summer of 1957 of the principle of timely flexibility in monetary policy will also be admitted. If mistakes in 1955 may justifiably be said to have encouraged subsequent inflationary developments, the errors in 1957 may be said to have contributed to the sharpest business decline in the postwar period.

The successful application of the principle of timely flexibility depends on a reasonably good diagnosis of the current changes that are taking place in the economy. The monetary authorities are, of course, not omniscient, and are bound to make mistakes. They are not only engaged in practicing the difficult art of prevision but, unlike many other forecasters, they have the responsibility for making decisions with respect to the flow of credit, based on their judgments of the prospective business situation, which can seriously affect the entire economy. Recognizing both the limitations arising from the uncertainties attached to prompt discernment of economic changes and from a definite inclination on the part of the monetary authorities to unduly delay in taking the necessary steps, there are those who look with a dim view on the potentialities of monetary policy for promoting economic stability. Some skeptics advocate the use of impersonal devices which would signal both the need and time for action, thus minimizing errors originating in human psychology. Others place major reliance on the stabilizing power of different tools, such as fiscal policy.[49] Those, however, who regard monetary policy as an essential tool, among a variety of measures required in a stabilization

[49] John K. Galbraith, The Affluent Society, chs. 16 and 17, Houghton-Mifflin, 1958; testimony of Seymour E. Harris, Investigation of the Financial Condition of the United States: Hearings before the Committee on Finance, U. S. Senate, 85th Cong., 2d sess., April 1958, pt. 6, p. 1992 ff.

program, need not entertain illusions that human limitations can be overcome by the adoption of mechanical formulas, either in forecasting or in decision making. There are no mechanical substitutes for diagnoses based on the fullest use of the available evidence—often conflicting in character—nor can the necessity for the exercise of the age-old virtues of sound judgment, wisdom, and courage be eliminated from decisions for action. As a consequence, the process of identifying past errors and ascertaining the source of the miscalculations must be an ever-continuous one if we are to make progress in learning how to cope more effectively with the problems of economic instability.

The contrast between the record of the deliberations of the Open Market Committee, which stressed the sidewise movement of the economy during most of the year, and which expressed considerable uncertainty as to the business outlook, and the public statements and actions of the Federal Reserve, which emphasized that the central problem during the first 10 months was inflation, requires explanation. Similarly, the relatively sharp rise in the discount rate in August when business expansion was grinding to a halt is also in need of a more satisfactory explanation than has thus far been advanced by the monetary authorities. It is safe to predict that, long after the events of 1957 have passed, economists will seek the answer to these two questions.

If in the eyes of the Federal Reserve officials, inflation was the No. 1 problem, it would appear that, in part, it was because the main focus of their attention was on the continuous rise of consumer prices and interest rates. Insufficient attention was given to the fact that the underlying forces which were responsible for the boom and for inflationary pressures were fast becoming contractive influences—if due recognition were given to the time-lags that are operative in these sectors of the economy. This is not a matter of hindsight since there was cumulative evidence that the sidewise movement was more likely to tilt downward rather than upward. The index of industrial production had reached its peak in December 1956 at 147, slipped to 144 in April and May, and remained at 145 from June to August. New orders of manufacturers had been declining ever since the beginning of the year and unfilled orders dropped $6 billion between January and August. The average weekly hours of work in manufacturing was moving downward from 41 hours in December 1956 to 39.7 in July and employment in manufacturing industries was drifting downward in the same period. The index of spot prices of raw materials dropped steadily from 100.4 in December 1956 to 92.1, or a decline of 8 percent in 7 months. Corporate profits had been declining since the fourth quarter of 1956; exports were dropping since March of 1957; and Government contracts were being cut back by midyear. Above all, a number of the before-mentioned indicators and other signs pointed to the tapering off of the boom in the capital goods industries—a boom that had been a major influence in the inflationary pressures of 1956 and early 1957. In view of a rate of expansion of physical plant capacity, especially by manufacturing industries, that was much higher than that of output or sales since the beginning of 1956, this disparity could not continue indefinitely. In the words of the Federal Reserve Bank of New York, "the pace of current and planned business investment in capital equipment and in inventory had already reached such proportions, by 1956, that an eventual

slowing down for consolidation and reassessment could be considered inevitable." [50] To be sure, there was uncertainty as to "the timing and dimensions of such a slackening." [51] But in view of the fact that heavy commitments for capital outlays were made 1 to 1½ years earlier and that downward revision of investment programs was becoming increasingly evident by mid-1957, the fact that current capital outlays were at peak levels did not signify that a sharp decline in such expectations was not a near prospect.

In the light of these developments, the August rise in the discount rate remains inexplicable. When pressed on this point, the Chairman of the Federal Reserve Board insisted that the change was "necessary for technical reasons." [52] But what Mr. Martin appeared to ignore was the fact that a sharp hike in the rate was also widely interpreted as indicating that the monetary authorities regarded the intensification of inflationary pressures and the need for continuation of monetary restraint as the immediate issues facing the country. That a change in the discount rate is regarded as a signal to the public of a shift in Federal Reserve policy was expressly stated by the Board of Governors of the System when it lowered the rate in November.[53] If it was a public signal in November, it must also have been one in August.[54]

SOME CONCLUDING OBSERVATIONS

The sharp contrast between the deliberations of the Open Market Committee as revealed in the 1957 Annual Report of the Board of Governors of the Federal Reserve System and the public interpretations of their actions, as well as the misunderstandings with respect to the meaning and significance of the August hike in the discount rate, raise the question of the necessity for the secrecy surrounding the decisions of our monetary authorities. This question was raised by Senator Fulbright, Chairman of the Senate Banking and Currency Committee, during the course of interrogating Mr. Martin at the stock market hearings in March 1955. The chairman of the committee asked whether the Board of Governors gives any explanation for its actions when it announces changes in margin requirements. Mr. Martin replied that "Our actions should speak louder than our words. In this particular field, as in most central bank moves, it is by action rather than by announcement and statement that we get our results." [55] Mr. Fulbright then pointed out that failure to furnish an explanation for their moves results in misunderstanding of Federal Reserve policies.[56] If the absence of a forthright statement of policy changes resulted in faulty interpretations of Federal Reserve decisions

[50] Annual Report, 1957, Federal Reserve Bank of New York, p. 7.

[51] Ibid., p. 7.

[52] Federal Reserve Monetary Policies: Hearings before a subcommittee of the Committee on Banking and Currency, U. S. Senate, 85th Cong., 2d sess., February 1958, pp. 24–25. Senator Douglas' interrogation of Mr. Martin on the necessity for raising the discount rate at the very time when the economy had begun to slip is contained on pp. 20–28.

[53] Forty-fourth Annual Report of the Board of Governors of the Federal Reserve System, 1957, p. 70. The sign-aspect of the discount rate is also indicated in the following quotation from the 1957 Report of the Federal Reserve Bank of New York, p. 12: "By mid-November, it was decided to give all sections of the economy an unmistakable sign that the direction of credit policy had changed."

[54] It is interesting to note that there were differences within the System on the advisability of the August rise in the discount rate. "As was to be expected, when the underlying forces of the boom were beginning to wear out, there were differences of view, even within the central bank, over the need for this final overt step in the long sweep of the System's restrictive policy." Annual Report, 1957, Federal Reserve Bank of New York, p. 11.

[55] Stock Market Study: Hearings before the Committee on Banking and Currency, U. S. Senate, 84th Cong., 1st sess., March 1955, p. 571.

[56] Ibid., p. 572.

with respect to margin requirements at the beginning of 1955, there were more serious misunderstandings of the more general monetary controls that were exercised after mid-1957. The problem of providing the public with a clearer understanding of Federal Reserve policy changes through prompt publication of explanatory statements is of sufficient importance to warrant serious exploration in the near future.

There are other matters of an informational character relating to monetary policy that need strengthening. There have been numerous complaints recently by Federal Reserve officials concerning the adequacy of the statistical tools employed in arriving at policy decisions. The shortcomings of existing data and the need for additional and more timely statistical information essential for the appraisal of changing business conditions have been stressed in recent years by the Joint Economic Committee of the Congress and by the President's Council of Economic Advisers.[57] Progress toward filling the gaps in our knowledge of the operations of our economy through improvement of the Federal statistical programs depends upon more liberal appropriations for economic statistics. But this does not mean that even with their present resources Government agencies cannot initiate beneficial changes in their statistical programs.[58]

Our review of the financial and economic developments between 1950 and 1957 has discussed the successes and the inadequacies of monetary policy in promoting economic stability. The shortcomings have been of two kinds: (1) The actual use that was made of the available tools for monetary control; and (2) the limitations inherent in the existing tools. The recent boom followed by the sharpest recession in the postwar period has emphasized once more the necessity of a fundamental reexamination of our financial system with a view to increasing the effectiveness of monetary policy in a stabilization program. The setting up of a National Commission on Money and Credit for a period of 3 years under the auspices of the Committee for Economic Development should result in valuable information and analyses. But the committees of the Congress must continue to inquire into the operations of the Federal Reserve System in the more immediate context of the problems that face the country as the economy moves from expansion to contraction and to resumption of expansion with the probable renewal of inflationary pressures. In the light of the latter eventuality it is well to keep in mind the limitations revealed in the present report with respect to our existing monetary controls and the necessity for considering in the near future methods for strengthening our credit instrumentalities for the promotion of economic growth and stability.

[57] Economic Statistics: Hearings before the Subcommittee on Economic Statistics of the Joint Committee on the Economic Report, 83d Cong., 2d sess., July 1954, 363 pages; Economic Report of the President, January 1958, pp. 91–96.

[58] In the field of banking and monetary statistics, for example, it is essential to have easily available compilations of monthly data going back over extended periods of time. The latest extensive compilation in this area published by the Federal Reserve Board in 1943 was Banking and Monetary Statistics, statistics f banking, monetary, and other financial developments, November 1943, 979 pages.

APPENDIX

Member Bank Reserves, Reserve Bank Credit, and Related Items, 1950–57

[Averages of daily figures, millions of dollars]

Period	Reserve bank credit outstanding						Gold stock	Treasury currency outstanding	Currency in circulation	Treasury cash holdings	Deposits, other than member bank reserves, with Federal Reserve banks			Other Federal Reserve accounts	Member bank reserves		
	U. S. Government securities			Discounts and advances	Float	Total					Treasury	Nonmember [1]			Total	Required	Excess
	Total	Bought outright	Held under repurchase agreement									Foreign	Other				
1950—January	18,082	18,082	--------	101	464	18,649	24,420	4,597	27,220	1,314	472	1,420		719	16,520	15,585	936
February	17,705	17,705	--------	178	425	18,310	24,346	4,598	27,008	1,310	585	1,478		728	16,146	15,409	737
March	17,682	17,682	--------	170	386	18,242	24,311	4,600	27,043	1,307	638	1,331		752	16,081	15,298	783
April	17,608	17,571	37	140	385	18,136	24,247	4,601	27,062	1,313	695	1,250		764	15,898	15,204	694
May	17,486	17,486	--------	116	400	18,005	24,236	4,602	27,022	1,302	563	1,299		717	15,941	15,237	704
June	17,800	17,800	--------	84	437	18,325	24,231	4,605	27,026	1,299	512	1,372		759	16,194	15,426	767
July	18,129	18,129	--------	140	431	18,703	24,192	4,606	27,117	1,305	549	1,481		796	16,253	15,507	746
August	18,328	18,291	37	172	375	18,876	23,927	4,609	27,009	1,307	668	1,404		752	16,273	15,626	647
September	18,946	18,931	15	96	565	19,610	23,560	4,613	27,154	1,303	749	1,235		740	16,602	15,837	765
October	19,365	19,364	1	67	611	20,044	23,366	4,618	27,233	1,305	590	1,367		803	16,731	15,889	842
November	19,381	19,373	8	145	631	20,159	23,157	4,622	27,380	1,290	450	1,331		746	16,742	16,009	733
December	20,345	20,336	9	142	1,117	21,606	22,879	4,629	27,806	1,290	615	1,273		739	17,391	16,364	1,027
1951—January	20,699	20,682	17	213	924	21,839	22,523	4,635	27,304	1,297	368	1,199		742	18,088	17,263	825
February	21,733	21,703	30	330	1,219	23,286	22,249	4,637	27,145	1,290	842	1,255		734	18,907	18,279	627
March	22,333	22,316	17	242	1,084	23,663	21,909	4,639	27,171	1,289	603	1,212		730	19,207	18,494	713
April	22,975	22,970	5	162	842	23,983	21,806	4,640	27,179	1,292	632	1,252		750	19,324	18,491	833
May	22,438	22,395	43	438	806	23,686	21,757	4,643	27,324	1,291	640	1,243		696	18,892	18,302	590
June	22,797	22,783	14	170	940	23,913	21,755	4,647	27,548	1,286	280	1,162		731	19,309	18,475	834
July	23,059	22,996	63	194	1,026	24,285	21,757	4,656	27,859	1,291	405	1,158		756	19,229	18,473	756
August	23,123	23,035	88	292	843	24,263	21,790	4,666	27,951	1,288	483	1,104		719	19,174	18,470	704
September	23,259	23,171	88	338	1,062	24,664	21,906	4,674	28,213	1,284	576	1,055		721	19,396	18,675	721
October	23,834	23,826	8	131	1,012	24,982	22,104	4,682	28,387	1,283	451	977		802	19,868	18,952	916
November	23,364	23,364	--------	343	1,074	24,785	22,298	4,688	28,612	1,286	436	867		776	19,794	19,065	729
December	23,409	23,310	99	657	1,375	25,446	22,483	4,701	29,139	1,280	271	835		796	20,310	19,484	826

See footnotes at end of table, p. 79

Member bank reserves, reserve bank credit, and related items, 1950–57—Continued

[Averages of daily figures, millions of dollars]

Period	Reserve bank credit outstanding						Gold stock	Treasury currency outstanding	Currency in circulation	Treasury cash holdings	Deposits, other than member bank reserves, with Federal Reserve banks			Other Federal Reserve accounts	Member bank reserves		
	U. S. Government securities			Discounts and advances	Float	Total					Treasury	Nonmember [1]			Total	Required	Excess
	Total	Bought outright	Held under repurchase agreement									Foreign	Other				
1952—January	23,206	23,195	11	200	1,034	24,444	22,824	4,709	28,637	1,281	109	737		744	20,470	19,537	933
February	22,552	22,552	--------	365	904	23,826	23,039	4,719	28,406	1,294	352	799		738	19,995	19,300	695
March	22,634	22,626	8	314	937	23,890	23,278	4,728	28,437	1,283	333	845		790	20,207	19,322	885
April	22,448	22,448	--------	365	908	23,726	23,293	4,737	28,459	1,278	549	875		818	19,777	19,127	650
May	22,308	22,308	--------	573	818	23,704	23,297	4,740	28,557	1,281	553	838		745	19,767	19,139	628
June	22,617	22,505	112	585	936	24,144	23,308	4,751	28,843	1,282	328	601	242	767	20,140	19,431	709
July	22,798	22,617	181	1,092	890	24,786	23,348	4,756	29,028	1,270	306	681	279	791	20,535	19,926	609
August	23,027	22,983	44	1,059	734	24,824	23,346	4,765	29,088	1,276	501	785	259	720	20,306	19,657	649
September	23,471	23,433	38	723	856	25,055	23,343	4,778	29,343	1,275	326	766	231	721	20,514	19,736	778
October	23,657	23,644	13	1,093	927	25,681	23,340	4,788	29,555	1,276	550	688	253	876	20,611	19,963	648
November	23,638	23,527	111	1,577	954	26,172	23,338	4,796	29,904	1,278	591	689	297	803	20,744	20,087	657
December	24,400	23,876	524	1,633	1,262	27,299	23,276	4,806	30,494	1,271	569	745	290	832	21,180	20,457	723
1953—January	24,202	24,011	191	1,372	1,008	26,586	23,101	4,814	29,920	1,280	552	611	405	775	20,958	20,251	707
February	23,918	23,875	43	1,336	822	26,080	22,797	4,821	29,718	1,299	500	526	336	800	20,520	19,882	638
March	23,892	23,878	14	1,220	909	26,025	22,606	4,825	29,752	1,296	244	530	378	841	20,416	19,828	588
April	23,861	23,806	55	1,184	843	25,892	22,562	4,832	29,782	1,281	395	563	397	861	20,007	19,472	535
May	23,973	23,881	92	955	750	25,682	22,557	4,843	29,869	1,279	356	552	350	779	19,897	19,306	591
June	24,748	24,729	19	433	776	25,960	22,514	4,851	30,011	1,273	52	566	203	933	20,287	19,499	788
July	24,955	24,943	12	428	737	26,123	22,366	4,853	30,165	1,264	545	537	239	939	19,653	18,869	784
August	25,000	24,974	26	658	660	26,322	22,226	4,860	30,167	1,273	656	548	376	861	19,526	18,882	644
September	25,168	25,097	71	468	771	26,410	22,176	4,867	30,328	1,273	537	538	354	871	19,552	18,834	718
October	25,344	25,341	3	367	800	26,514	22,102	4,873	30,366	1,274	557	463	406	889	19,536	18,784	752
November	25,172	25,078	94	494	744	26,413	22,057	4,878	30,555	915	497	434	424	805	19,718	19,035	683
December	25,639	25,218	421	448	1,018	27,107	22,028	4,885	30,967	767	602	466	390	908	19,920	19,227	693
1954—January	25,263	25,149	114	118	861	26,243	22,015	4,891	30,282	778	201	453	422	834	20,179	19,243	936
February	24,770	24,729	41	308	667	25,746	21,957	4,904	29,903	811	568	470	429	870	19,557	18,925	632
March	24,633	24,620	13	205	712	25,553	21,963	4,920	29,800	813	490	494	352	913	19,573	18,881	692
April	24,635	24,632	3	151	696	25,483	21,966	4,941	29,755	825	584	481	427	926	19,392	18,627	765
May	24,689	24,680	9	172	640	25,503	21,971	4,954	29,773	830	486	531	412	864	19,533	18,817	716
June	24,998	24,960	38	166	710	25,876	21,927	4,956	29,856	815	602	553	321	941	19,670	18,813	857
July	24,771	24,761	10	104	695	25,571	21,926	4,959	29,968	810	498	632	409	973	19,164	18,329	835
August	23,989	23,930	59	210	654	24,855	21,871	4,960	29,896	806	591	536	464	916	18,478	17,638	840
September	23,941	23,928	13	170	725	24,838	21,809	4,967	29,991	796	541	522	431	929	18,403	17,628	775

October	24,485	24,472	13	254	720	25,459	21,787	4,973	30,077	797	610	455	444	944	18,893	18,173	720
November	24,661	24,654	7	345	769	25,776	21,724	4,979	30,287	800	492	416	393	883	19,207	18,393	814
December	24,917	24,888	29	407	992	26,317	21,711	4,982	30,749	805	443	439	365	929	19,279	18,576	703
1955—January	24,200	24,182	18	444	805	25,449	21,714	4,985	30,110	819	341	477	383	903	19,114	18,432	682
February	23,838	23,787	51	473	710	25,021	21,715	4,990	29,784	826	477	420	473	927	18,819	18,195	624
March	23,619	23,604	15	566	804	24,989	21,718	4,996	29,790	823	690	363	442	960	18,635	18,050	585
April	23,632	23,604	28	585	838	25,070	21,680	4,997	29,807	816	501	370	481	973	18,800	18,210	590
May	23,666	23,617	49	445	798	24,924	21,673	4,999	29,861	818	421	389	432	928	18,746	18,166	580
June	23,598	23,596	2	465	878	24,958	21,676	5,001	30,050	825	329	412	345	959	18,715	18,146	569
July	23,967	23,925	42	576	940	25,497	21,680	5,003	30,284	801	461	423	423	962	18,824	18,205	619
August	23,886	23,870	16	803	746	25,450	21,682	5,004	30,289	801	569	431	398	918	18,728	18,152	576
September	23,709	23,668	41	872	924	25,525	21,682	5,006	30,420	797	540	386	392	968	18,711	18,148	563
October	23,951	23,881	70	895	926	25,792	21,685	5,008	30,532	781	509	390	403	1,000	18,870	18,345	525
November	23,997	23,963	34	1,018	1,055	26,089	21,687	5,008	30,791	778	538	394	444	937	18,902	18,378	524
December	24,602	24,318	284	840	1,389	26,853	21,689	5,008	31,265	777	434	459	394	983	19,240	18,646	594
1956—January	23,897	23,824	73	808	1,152	25,879	21,692	5,008	30,620	787	356	404	354	921	19,138	18,586	552
February	23,401	23,375	26	800	965	25,183	21,694	5,011	30,214	796	480	364	351	973	18,709	18,177	532
March	23,522	23,449	73	993	987	25,517	21,711	5,013	30,256	783	532	349	350	1,048	18,924	18,340	584
April	23,410	23,393	17	1,060	925	25,411	21,735	5,018	30,245	783	545	338	338	1,067	18,847	18,320	527
May	23,322	23,262	60	971	928	25,237	21,768	5,028	30,322	785	556	331	322	982	18,735	18,268	467
June	23,522	23,486	36	770	1,206	25,516	21,795	5,033	30,536	778	485	315	304	991	18,933	18,359	574
July	23,580	23,573	7	738	1,263	25,599	21,826	5,032	30,751	771	521	300	280	999	18,836	18,237	599
August	23,530	23,488	42	898	910	25,357	21,855	5,038	30,650	774	504	318	275	946	18,783	18,224	559
September	23,728	23,695	33	792	1,198	25,737	21,880	5,043	30,803	772	523	356	237	946	19,024	18,446	578
October	23,781	23,742	39	715	1,182	25,698	21,906	5,048	30,864	776	487	337	299	950	18,939	18,419	520
November	24,024	23,951	73	745	1,300	26,097	21,910	5,056	31,198	774	456	308	313	845	19,169	18,579	590
December	24,765	24,498	267	706	1,633	27,156	21,942	5,064	31,775	772	463	372	247	998	19,535	18,883	652
1957—January	24,092	24,056	36	432	1,343	25,905	21,989	5,067	31,040	794	335	323	276	896	19,295	18,773	522
February	23,111	23,083	28	665	1,106	24,912	22,279	5,071	30,595	817	336	335	294	1,071	18,816	18,302	514
March	23,061	22,997	64	859	1,024	24,968	22,305	5,081	30,568	812	423	316	216	1,135	18,884	18,366	518
April	23,239	23,121	118	1,036	1,110	25,411	22,313	5,090	30,614	803	429	348	339	1,195	19,087	18,580	507
May	23,041	22,996	45	931	1,046	25,041	22,358	5,098	30,645	792	521	361	276	1,075	18,827	18,362	465
June	22,989	22,917	72	1,009	1,170	25,189	22,621	5,106	30,902	782	490	393	290	1,077	18,982	18,485	497
July	23,351	23,198	153	917	1,175	25,466	22,625	5,108	31,116	769	480	377	279	1,048	19,129	18,595	534
August	23,146	23,129	17	1,010	989	25,166	22,626	5,115	31,035	764	490	349	273	1,163	18,834	18,300	534
September	23,325	23,302	23	994	1,147	25,489	22,627	5,121	31,143	763	547	378	271	1,180	18,956	18,434	522
October	23,348	23,252	96	818	1,143	25,326	22,660	5,129	31,109	780	495	338	258	1,097	19,040	18,573	467
November	23,417	23,276	141	810	1,126	25,373	22,743	5,137	31,335	793	464	322	337	1,044	18,958	18,447	512
December	23,982	23,615	367	716	1,443	26,186	22,769	5,144	31,932	768	385	345	186	1,063	19,420	18,843	577

[1] Nonmember deposits, January 1950–June 1952, represent total of foreign and other.

Source: Board of Governors of the Federal Reserve System.

COMMENTS OF STAFF OF FEDERAL RESERVE BOARD

LETTER OF TRANSMITTAL

BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM,
Washington, September 15, 1958.

Hon. J. W. FULBRIGHT,
Chairman, Senate Committee on Banking and Currency,
United States Senate, Washington 25, D. C.

DEAR SENATOR FULBRIGHT: Thank you for your letter of August 26 inviting comments by the Board's staff on the revised draft of the paper, enclosed with your letter, prepared by Dr. Asher Achinstein of the staff of the Legislative Reference Service of the Library of Congress under the heading, "Federal Reserve Policy and Economic Stability, 1951–57."

Because we ourselves are continually studying and reviewing System experience to search out the lessons it may hold in guidance for the future, the Board and its staff welcome efforts by others to review System policies and actions critically in development of standards for a more perfect execution of monetary responsibilities.

As the attached comments by our staff indicate, however, it is disappointing that this paper, while fully explicit as to the personal evaluation of the author, fails to state what monetary actions may or may not be expected to accomplish in economic stabilization or to set forth any standards for measuring the performance of monetary policy. This omission deprives the reader of a basis for judging either the validity or objectivity of the author's conclusions.

The Board will appreciate having the attached comments published in the printed report along with this letter.

Sincerely yours,

WM. MCC. MARTIN, Jr.

Comments by the Staff of the Board of Governors of the Federal Reserve System on the Report "Federal Reserve Policy and Economic Stability, 1951–57," by Dr. Asher Achinstein of the Legislative Reference Service of the Library of Congress

The report has been reviewed with care in recognition that critical evaluation may help toward perfecting the application of monetary policy. From this point of view, the paper suffers from three major defects.

First, its economic analysis envisages a more drastic recession in 1958 than actually developed. The author's views were formulated before it was generally realized that the 1957–58 recession had come to an end. Hence, the paper reflects, both explicitly and implicitly, the general foreboding of early last spring that the recession of 1957–58 would be long and severe. The same forebodings were prevalent during the downturn phases of the recessions of 1948–49 and 1953–54. Happily, in all three cases forebodings proved wrong. For the third time in the postwar period, recessionary tendencies in this country have proved to be short-lived adjustments and have been followed by renewed and vigorous expansion.

Much of this paper—and particularly the discussion of 1957—would now need revision. For example, from a reading of this document anyone would be surprised to learn that, even before it had been published, the recession of 1957–58 was regarded as among the shortest and mildest (in terms of total man-hours of work lost in the economy as a whole) in American history. Surely, this fact is relevant to any judgment on the precautionary policies pursued by the Federal Reserve System in 1957.

There is, and has been, practically no informed opinion among economists that fluctuations in business activity can be entirely eliminated from a free market economy. Accordingly, it is out of focus to concentrate, as does the author, on the fact that fluctuations occurred. The ideal, and aspiration, has been that instability be minimized. The question for objective appraisal is whether or not Federal Reserve policies since 1951 have tended to mitigate or to accentuate economic instability. This question, moreover, must be considered in relation to the actual situation when monetary actions were taken, including any concurrent actions of a stabilizing or destabilizing nature by other Government agencies. Thus considered, a judicious view would surely be that without the monetary actions taken by the Federal Reserve since 1951 the booms would have been more exuberant and the recessions more severe.

Second, the author attempts to evaluate the effectiveness of monetary policies without adequate recognition of the principles and guides on the basis of which these policies have been determined, or presentation of an alternative set of standards. As a result, the paper has serious limitations for a reader seeking a balanced appraisal of the effects of Federal Reserve policy. What, for example, should be the

relation of monetary actions to stability or instability in the economy? Also, are Federal Reserve actions the sole factor for stability on the side of public responsibility, or is economic stability also affected by taxing and spending policies, by agricultural policies, and by other public policies such as those that govern the terms and conditions in the insurance and guaranty of home mortgages? If other public policies also influence economic stability, is it not incumbent upon the author to state concretely and definitely his concept of the relative role of monetary policy in the years discussed and to analyze the extent to which monetary policy was aided or vitiated by other public actions?

Third, the paper fails to deal adequately with the most persistently grave threat to economic stability during the postwar period—inflation. At some points, it ignores inflation as a problem, and at others it plays down the problem.

For example, the paper evaluates Federal Reserve policy actions in 1956–57 as though the economy were not in the grip of an active wage-price spiral. It ignores the growing tendency throughout the economy after mid-1956 to hedge against inflation by incorporating in longer term contracts escalator clauses for higher wage and other costs, and the consequent speeding up of the wage-price spiral. It also ignores the growing tendency on the part of business management in this period to anticipate future construction needs in an effort to avoid expected future increases in construction costs, and the effects of these anticipatory decisions on construction costs and surplus plant capacity. As a result the paper gives inadequate recognition to the effect of the developing inflationary psychosis on the prices of fixed-interest securities, and on the level of long-term interest rates.

Expectations of renewed inflation are at least as widespread today as they were in the early summer of 1957. They constitute the major current threat to the continued progress of our recovery. Investors are being urged on all sides to shift their holdings to common stocks as hedges against inflation. This is illustrated by the growth and formation of investment trusts and by the decisions on the part of private pension trusts to increase the proportion of common stocks to bonds held in their portfolios. The sale of bonds—which constitutes the only means for raising market funds to finance public expenditures, State and municipal as well as Federal, and a principal means of financing industrial growth—is being seriously handicapped. Today, prices of common stocks have risen to a point where their average yields are below the yields of senior bonds of the same corporations and at approximately the same level as average yields on United States Government securities.

Additional points which may be helpful in reading the paper are:

(1) In its criticism of monetary actions through open market and discount operations, no account is taken of the complications caused by Treasury debt management problems and the relation of Treasury refinancing and financing operations to the timing of monetary actions.

(2) Unfavorable comments on the use of available instruments for monetary policy are frequently accompanied by favorable comments on the possible revival of regulation of mortgage credit and of consumer credit, the authority for which, as supplementary instruments of credit control, has been discontinued by the Congress. And yet the paper offers no analysis of the problems or limitations of the latter type of instrument.

(3) In his detailed comments on restrictive Federal Reserve policy in 1952–53, 1955, and 1957, the author appears to favor a sledge-hammer approach of sharper and more rapid actions on the basis of forecasts presumed to be accurate. Perhaps preoccupation with the sledge-hammer approach in applying monetary actions accounts for the author's surprise that the Federal Open Market Committee through the first three quarters of 1957 was weighing meticulously all aspects of the current economic situation in order to detect promptly any evidences of downturn. The Federal Open Market Committee's record was entirely consistent, of course, with the System's public posture of monetary restraint during the period in view of the evidence that the economy was in the grips of a demand-pull cost-push inflation and of the danger that speculative excesses would lead to serious liquidation and severe economic recession.

(4) The paper suggests some avenues of inquiry that afford promise, as for example when it takes up in critical vein what it terms certain limitations in the use of the tools of monetary policy, and fiscal and debt management policy, for promoting economic stability. However, the inquiry does not go beyond recognizing that the fallibility in foreseeing the future that attends all forms of human endeavor extends to monetary policy. Indeed, the author makes the point that monetary policy has unusual virtues, at least in comparison with fiscal policy and debt management policy, in that its flexibility enables the monetary authorities to minimize errors of diagnosis by more speedily steering a different course to meet changing conditions.

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