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FEDERAL RESERVE BANK
OF
PHILADELPHIA

(ZONE 1)

OFFICE OF THE
PRESIDENT

March 31, 1958

The Honorable Harry F. Byrd
Chairman, Committee on Finance
The United States Senate
Washington 25, D. C.

Dear Senator Byrd:

Since Mr. Alfred H. Williams retired from the presidency of the Federal Reserve Bank of Philadelphia on February 28, 1958, I am responding as his successor to the questions you addressed to him in his official capacity.

I share the view of the Presidents of the other Reserve Banks that we will make our maximum contribution to your extremely important inquiry if we follow generally the procedure established in responding to the inquiries received from Senator Douglas in 1949 and from Representative Patman in 1951. This procedure has the great advantage of assuring that the whole area of your interest will be covered while enabling each President to concentrate on those aspects that concern him or that have occupied his particular attention over the years and on which his judgment may be of some value. My complete response, therefore, consists of the enclosed document "Comments in Response to Questionnaire of the Senate Finance Committee," which was prepared by our staff committee, and this covering letter.

I am sure you appreciate that discharge of imperative but unique time-consuming duties during my first month in office has made it impossible to devote as much time to the inquiry as its importance requires or as much time as I desired to give. My available time, therefore, was spent on a discussion of a few basic ideas. It has not been possible to develop necessary qualifications or to polish

the phraseology.

The discussion is directed to three questions, as follows:

1. Has the rapid development of financial intermediaries changed the essential role of general monetary policy?
2. Has market structure been the source of uneven impact of credit restraint?
3. Should the monetary authorities direct their policies toward achieving a predetermined rate of growth of the economy?

1. Has the rapid development of financial intermediaries changed the essential role of general monetary policy?

A view that has gained considerable support in recent years is that the rapid development of financial institutions other than commercial banks has weakened seriously the influence of central banks and the role of general monetary policy. Stripped of qualifications, the reasoning that leads to this conclusion runs about as follows:

The monetary authorities regulate the amount of reserves available to the commercial banks. Commercial banks adjust their lending and investing activities to their reserve positions and thus influence the amount of deposit money. When reserves are tight in a period of restraint, banks will limit their lending by charging more and by screening applications more rigorously. If banks are the only source of credit open to borrowers, the restraining monetary policy can be effective. If, on the other hand, borrowers can turn to other sources, the influence of the monetary authorities is dissipated.

My own view is that the essential ingredient of general monetary policy is the power of the monetary authorities to influence significantly the terms and

FEDERAL RESERVE BANK OF PHILADELPHIA

GEN NO. 3 TO The Honorable Harry F. Byrd

3/31/58

conditions under which the public can secure the amount of cash balances that it needs. This judgment in turn is based on the belief that the attractiveness of cash relative to debt assets on the one hand and real assets on the other influence the flow of expenditures and thus the general level of economic activity.

The power of the Federal Reserve System to tighten credit may be measured in dollar terms by its portfolio of earning assets plus the amount by which existing member bank reserve requirements fall short of the legal maximum. The order of magnitude at present is in excess of \$25 billion. The power of the System to ease credit is limited by the requirement that the Reserve Banks maintain a gold certificate reserve equal to at least 25 per cent of their note and deposit liabilities and by the extent to which existing member bank reserve requirements exceed the legal minimum. The dollar amount at present exceeds \$40 billion. The magnitudes are obviously adequate in both directions.

I do not wish to create the impression that it is easy to decide the terms and conditions that are appropriate at any given time to produce the desired results. On the contrary, I have found this an extremely difficult and not always successful undertaking. But that is the basic decision on which attention should be focused.

As far as financial intermediaries are concerned, it should be remembered that they do not operate in a vacuum. They operate in organized and in customers' money and capital markets which are influenced by monetary policy. In fact, one consequence of the institutional developments of recent decades is that both borrowers and lenders have more options. A man who wishes to finance the purchase of a house or of an automobile can apply at several different types of institutions. Alternatively, one who wishes to save in liquid forms has numerous options. Banks

FEDERAL RESERVE BANK OF PHILADELPHIA

PAGE NO. 4 TO The Honorable Harry F. Byrd

3/31/58

and other institutional lenders in turn may lend to consumers, to home owners, to business firms, and others. Is it not reasonable to suppose that as the number of options increases - as the network of credit contacts becomes more elaborate - the influence of the monetary authorities permeates the economy more thoroughly and more quickly? Incidentally, doesn't the widespread ownership of the Federal debt operate in the same direction? Doesn't the credit market become more fluid and doesn't the burden of distributing credit fall more on price and less on administration or rationing?

Nevertheless, the allocation of credit among competing users is an area of recent financial developments that merits much more study. So, also, does the question of competitive relationships among various financial institutions.

My judgment as to the nature of the problem that confronts us is reinforced by an analysis of two earlier instances in which some observers also concluded that central banks were losing their effectiveness.

Although the two episodes differ in detail from current developments in the United States, the basic issue is the same. It is that growing competition of other lenders who presumably escape control can nullify the effects of actions by the central bank. At times the complaint was directed against competition from other banks with limited powers of issue and at times against competition of commercial banks with the central bank rather than between nonbank and bank lenders, but the essential core of the problem has been the same.

The first episode concerns the operations of the Reichsbank from 1876 to 1914. During the first half of the period the complaint was that the banks with limited powers to issue notes were nullifying the powers of the Reichsbank and during the second half it was that the commercial banks were doing so.

FEDERAL RESERVE BANK OF PHILADELPHIA

GEN. NO. 5 TO The Honorable Harry F. Byrd

3/31/58

The case of the Reichsbank is particularly relevant because the mechanism of control, when viewed from today, was so loose-jointed. The facts are that: (1) before the First World War the Reichsbank paid virtually no attention to reserve balances and ordinarily did not even know what their magnitude was; (2) it did not try to establish their amount at predetermined levels; (3) it was not in a position to do so quite apart from the question of controlling its own assets because of the magnitude of the variations in its other accounts; and (4) German commercial banks did not maintain either their reserve deposits at the Reichsbank or their total primary reserves at any customary relationship to deposits.

The argument was that any pressure the Reichsbank tried to exert could be absorbed by the other banks through the simple expedient of allowing their own reserve ratios to decline. In fact, by allowing their ratios to decline sufficiently, they could move in the opposite direction from that desired by the Reichsbank. Similarly, they could absorb any ease the Reichsbank was trying to create by allowing their reserve ratios to rise.

There is, of course, something to this argument. By allowing their reserve ratios to vary, the other banks could absorb or release some of the reserves the Reichsbank was creating or destroying. It does not follow, however, that they could defeat the Reichsbank's intentions. What the variable reserve ratios meant was that the Reichsbank had to conduct operations on a larger scale in order to achieve a given result because it had to offset the effects of the actions of the other banks.

The fact is that the Reichsbank had sufficient power at all times to do this. Whatever reserves the commercial banks wished to keep had to be secured from the Reichsbank whose earning assets were always much larger than the total cash

FEDERAL RESERVE BANK OF PHILADELPHIA

PAGE NO. 6 TO The Honorable Harry F. Byrd

3/31/58

assets of the commercial banks. The Reichsbank was also able to influence directly the terms and conditions under which certain other borrowers acquired cash because it was a large commercial bank as well as the central bank. A conclusive demonstration of the Reichsbank's power is that it was able, despite all these impediments, to achieve throughout this period its over-riding objective, which was to maintain convertibility of the mark.

The second episode concerns the Bank of England in the 19th Century. Professor Elmer Wood of the University of Missouri has made an exhaustive study of the experience. The question at that time was whether the so-called country banks which had authority to issue redeemable notes could escape the control of the Bank of England by reducing their reserve proportions. Professor Wood concludes that they could not do so because, as he puts it, "at no time down to 1913 were the total private securities of the Bank unmanageably small in relation to total bankers cash. Whether the banks, therefore, chose to adjust their reserve proportion at 8 per cent or 15 per cent, the terms of the Bank had to be met."

I have cited these two experiences because they contain elements that are relevant to our own problem. Indeed, the conditions that presumably impeded the Reichsbank and the Bank of England were stronger than the conditions now confronting the Federal Reserve System. They were dealing with money-creating institutions whereas we are concerned with financial intermediaries. These latter can influence the flow of purchases - which is what really concerns us - only by affecting the efficiency in the use of money - or velocity of circulation as it is called technically - whereas the former could influence not only velocity but the actual quantity as well.

PAGE NO. 7 TO The Honorable Harry F. Byrd

3/31/58

2. Has market structure been the source of uneven impact of credit restraint?

An area of general monetary policy that needs much more study than it has yet received is the precise impact of that policy on various sectors of the economy. My immediate concern about this problem is that some observers are tempted to reach firm conclusions on what seems to me to be limited analysis and evidence.

We must begin by recognizing that if credit restraint is to be effective it must result in postponing some spending that would otherwise have taken place. It is obvious that these postponements will not be proportional to the actual expenditures of all spending units. The impact will not be uniform.

I shall analyze briefly one theory that has been advanced to describe the differential impacts. This is not a field in which I have specialized and the analysis is tentative. My sole purpose is to indicate that we should not rush to adopt solutions before we understand the problems that confront us.

The particular theory is that general credit restraint sorely handicaps "competitive-price industries" and leaves virtually untouched the "administered-price industries." In some versions, the conclusion seems to result from a rather unusual classification of industries between the two categories, with housing and "other industries where firms are small and numerous" classified as competitive-price industries.

The inclusion of housing is particularly interesting. Since housing starts fell from about 1.3 million in 1955 to 1.1 million in 1956 and to 1.0 million in 1957, it is tempting to some to include home building among competitive-price industries.

It seems to me that prices of new houses are administered prices; just

FEDERAL RESERVE BANK OF PHILADELPHIA

RECEIVED NO. 8 TO The Honorable Harry F. Byrd

3/31/58

as administered as, say, the price of an automobile at the dealer's showroom. There are many thousands of homebuilders in this nation. But housing sells in a local market. Housing starts in Los Angeles have little or no effect on house prices in Philadelphia. Each homebuilder erects individualized houses. His price is determined by his costs, the home's location, and what he thinks the market will pay. But he sets the price. It is no more subject to fluctuation than most other administered prices. (In this connection it is interesting to note that housing prices were 7 or 8 per cent higher in 1957 than in 1955, despite a decline of one-fifth in starts.)

Perhaps it would be profitable to debate whether homebuilding is a competitive-price industry. Certainly, there is room for some argument. But there is widespread agreement as to why credit restraint had an unusually severe impact on housing in 1956 and 1957. And the answer has nothing to do with market structure. The figures below pretty much tell the story.

Private Starts
(000 omitted)

	<u>FHA</u>	<u>VA</u>	<u>Conventional</u>
1955.....	276.7	392.9	639.9
1956.....	189.3	270.7	633.9
1957.....	168.4	128.3	694.4

Housing starts slumped off in the Government-guaranteed and insured sector. There was an actual increase in houses started under conventional financing. (No one would want to argue that homebuilding of conventionally financed housing is characterized by administered prices and that government-insured starts are competitively priced.) The "sticky" interest rates on FHA and VA mortgages unquestionably had a great deal to do with this disparity. Interest yields for lenders on

FEDERAL RESERVE BANK OF PHILADELPHIA

GE NO. 9 TO The Honorable Harry F. Byrd

3/31/58

government-insured mortgages were not attractive. Funds went elsewhere.

Housing starts were dramatically affected by tight money, not because homebuilding is a competitive-price industry but mainly because FHA and VA interest rates did not slide freely with general interest rates.

Some of those who emphasize market structure classify "other industries where firms are small and numerous" as competitive-price industries. Not all small businesses, however, fall neatly into this category. For example, there are smaller manufacturers of appliances, of steel, of automobiles.

The question of whether credit restraint handicaps small business unduly is now being studied extensively by the Federal Reserve System. My own judgment will be deferred until that study is completed. At this point I certainly am not convinced that small businesses in administered-price industries escape the effects of credit restraint while those in competitive-price industries feel the effects unduly.

Agriculture is another industry on which credit restraint is alleged to have had undue impact because it is a competitive industry. We should recognize at the outset that not all of agriculture is competitive. We may admit that we do not know the answer.

We do know, however, that we had a farm problem before we had tight money. We also know that even with tight money our farmers were able to grow more farm products than the market would take. It seems likely that difficulties in the farm sector arose not primarily because it was a competitive price industry; but rather because the industry has been undergoing a basic readjustment. It was a weak industry before, during, and after tight money.

The general idea that monetary policy might have an uneven impact is not

FEDERAL RESERVE BANK OF PHILADELPHIA

GE NO. 10 TO The Honorable Harry F. Byrd

3/31/58

new. Few individuals would assume that a very broad-based, general control of credit must have an exactly proportionate impact on the various firms and industries within our economy. Obviously, there are times when certain sectors will be more responsive to monetary actions. The reasons for this uneven impact are not difficult to understand. A restrictive monetary policy, stripped to its bare essentials, is supposed to bring current investment spending into line with the current volume of savings.

Investment spending pretty much depends on current sales and profit margins and on an evaluation of future sales and profit potentialities. If firms are enjoying high levels of demand pressing on current capacities; and if it appears demand will grow as the economy expands; these firms probably will be inclined to increase spending for inventory and to enlarge productive capacity. This is especially the case if current price levels are enabling good profit margins. Firms with less buoyant demand, somewhat dimmer prospects, and poorer profit positions are not so strongly inclined toward freewheeling spending on inventory and new plant capacity.

A policy of credit restraint probably will seem to have a much more immediate and drastic impact on the latter firms. The firms themselves will be more readily discouraged by the increased cost of borrowing. In addition, lenders will tend to "screen out" these firms as less credit worthy than some others. These seemingly obvious points must be pressed to show that these differing demand and profit positions, which explain the uneven impact of monetary policy among firms, can also explain its uneven impact among industries.

Surely, during any boom period the demand for the products of some industries is stronger than that for others. Investment spending of these industries

FEDERAL RESERVE BANK OF PHILADELPHIA

PAGE NO. 11 TO The Honorable Harry F. Byrd

3/31/58

will seem less affected by credit restraint than others where demand pressures and profit positions are not so strong.

I have presented this analysis to indicate why I am not convinced that market structure was responsible for such uneven impact as the credit restraint in 1956 and 1957 may have had. This, of course, is not the same thing as saying that administered-price industries respond to credit restraint in the same way as competitive-price industries. They probably do not.

Prices in administered-price industries very possibly respond somewhat slowly to changes in demand. In these industries the initial responses to a decline in demand are likely to occur in cutbacks in production and employment. Competitive-price industries probably respond in a different manner. Prices in these industries are more likely to be immediately sensitive to changes in demand. Changes in production and employment would come about somewhat more slowly.

If this likely sequence of responses is accurate, it has implications for monetary policy. Since a large fraction of our measured prices are set by administrative action, it may mean for example that the consumer price index is a tardy indicator of the impact of monetary policy.

FEDERAL RESERVE BANK OF PHILADELPHIA

GENO. 12 TO The Honorable Harry F. Byrd

3/31/58

3. Should the monetary authorities direct their policies toward achieving a predetermined rate of growth of the economy?

A rising standard of living in the sense of more goods and services to consume is made possible only by an increase in real output per capita. Let us admit that growth is desirable; it does not follow that monetary policy should be directed toward achieving a predetermined rate of growth each year. It is possible that policies directed toward that goal could actually inhibit long-term growth.

Economic growth is compounded from many ingredients. One of the most important is that some individuals are motivated by an insatiable desire to comprehend the universe of which we are a part and devote their lives to what has been called basic research. It is the men of genius in basic research who have contributed most to our progress. I believe such individuals flourish most in an environment of freedom. In the interest of growth, I would promote such an environment rather than place on it the limits that might be necessary to achieve a specified rate of growth in the short run.

Related to basic research in achieving growth is technological progress. Technology embraces the application of a wide range of human knowledge to the productive process. It includes scientific discoveries as well as the invention of new machines and new processes of production. The development of new seeds and improved breeds of livestock have contributed significantly to the increase in agricultural output. It was the work of scientists which led to such significant discoveries as synthetic fibers, plastics, electronic products and processes, and atomic energy. Restless minds and scientific research are the sources of innovation - in materials, in productive processes, in machines, and in managerial skills.

FEDERAL RESERVE BANK OF PHILADELPHIA

GEN. NO. 13 TO The Honorable Harry F. Byrd

3/31/58

New discoveries and new inventions in themselves, however, add little to our total output of goods and services. There remains the problem of fashioning an efficient process for producing the product, building a plant and equipping it with the necessary machinery, and developing a market in order that the product may be produced in volume. This is the work of the entrepreneur. For scientific discoveries and innovations to be fruitful, substantial sums are usually required for investment in plant, new machinery and equipment.

Another ingredient of economic growth, therefore, is saving and investment. If we are to have the investment that technological progress requires, we cannot consume all of our current output. There must be saving - abstaining from current consumption - to release resources for the capital goods needed in expanding our productive capacity. The more we consume, the higher our current standard of living but the slower our rate of economic growth. The more we save and invest the lower our current standard of living, but the more rapid our rate of growth.

Productive capacity is determined by the character as well as the total volume of investment. Some types of investment contribute to productive capacity more than others. Investment in houses and durable consumers goods, for example, usually adds less to productive capacity than investment in manufacturing plant and equipment and in mining.

Mobility of resources is another ingredient of economic growth. Technological progress means change. Change is the essence of a dynamic growing economy. As industries producing new products expand, those producing products rendered obsolete decline. Growth will tend to be more rapid, the more promptly labor and capital shift to meet changing demands. Attempts to support or "prop up" declining industries, by postponing the shifting of resources, retard the rate of

economic growth.

Another ingredient of growth is the intensity and nature of the desires of the public. People work because they want something - more food, better clothing, an automobile, a home, better education for their children, more security. In this country a strong desire for such things has been a powerful force in stimulating demand for goods and services, and in providing the human and material resources necessary to produce them. With a lesser desire for material things our rate of economic growth would undoubtedly have been slower.

The rate of growth thus depends largely on choosing among alternatives - choices that involve basic social, as well as economic values. In the present state of international tension, adequate defense is essential for our security, and to protect our freedom. If we are to preserve our way of life, defense needs must have priority in the allocation of our resources. The large volume of expenditures required for adequate defense, provides strong support for a high level of total output. It also provides a strong tendency toward instability. As new weapons are discovered, old ones are rendered obsolete. Labor, plant and equipment must be shifted from the old to production of the newer type weapons. The recent shift in emphasis from aircraft to missiles is a case in point. Even though total defense expenditures remain the same, a shift in the pattern of expenditures may result in declining production and employment in some industries and an increase in others.

Another choice that has a significant influence on our rate of economic growth is the division of current output between consumption and saving and investment. This raises a baffling question, particularly with a standard of living as high as that which now prevails in the United States. To what extent should we abstain from consumption and reduce our current material standard of living in

PAGE NO. 15 TO The Honorable Harry F. Byrd

3/31/58

order that posterity, which, barring a nuclear war, will almost certainly have a higher standard in any event, may have an even higher standard of living? What is the optimum blend of consumption and saving, in terms of human welfare - social and spiritual as well as economic?

Growth also depends in part on our relative preference for progress and security. Technological advances open up new opportunities but they also inflict losses and hardships. Some of our existing investments are rendered obsolete and workers trained and experienced in the older technology may find that their services are no longer in demand. Temporary unemployment and losses on existing investments are a part of the price we pay for changes which contribute to growth. The desire to protect existing investments and jobs frequently leads to attempts to delay the introduction of new and improved technology. The price of such temporary security, however, is a slower rate of economic growth.

Another factor influencing the rate of growth is the proportion of our population employed and the number of hours worked per week. The larger the proportion of the population employed and, within limits, the longer the hours worked per week, the higher output per capita will be. Should the labor force be enlarged by encouraging youths, women, and older people to take jobs? Would the additional output thereby achieved be worth the sacrifices involved in terms of the education and training of youth and life in the home? Which would provide greater satisfaction - more leisure or having the larger amount of goods which might be produced by working longer hours?

Directing monetary policy toward the attainment of a predetermined annual rate of growth involves some basic difficulties. One is that a decision as to specific rate of growth to be used as a target involves appraising a whole range of

intangible human values. How does one determine whether it is economically and socially desirable to consume less now in order to have more in the future? To undergo temporary hardships and insecurity to promote progress? To have substantial inequality in income which would provide a stronger incentive for individual effort and initiative? Or to use more of our time for work and less for leisure? Choices such as these have a significant influence on the welfare of the individual as well as that of society as a whole.

A second difficulty is that monetary policy has little direct influence on the principal ingredients of economic growth. It is not an effective means for directly influencing research and the rate of technological progress; promoting individual freedom and initiative; or encouraging people to work more rather than to enjoy more leisure. It is for this reason that undue emphasis on growth as such would tempt the authorities to search for more effective weapons. Directing the flow of credit to "preferred" uses is an obvious possibility. Should we elect to go down that road, I fear we would discover in due course that we had created more problems than we had solved and that our actual rate of growth or our current standard of living would be less.

My conclusion is that monetary policy can make a significant contribution to growth. It can make its maximum contribution, however, by promoting an economic environment favorable to growth not by seeking to achieve a predetermined rate of growth.

Monetary policy will make its maximum contribution by promoting a reasonably full use of resources at a reasonably stable level of prices. An appropriate supply of credit and money should be made available to foster rather than inhibit growth. Beyond that, however, the factors determining the precise rate of economic

FEDERAL RESERVE BANK OF PHILADELPHIA

ENCL. NO. 17 TO The Honorable Harry F. Byrd

3/31/58

growth can best be left to the decisions of individuals rather than to the monetary authorities or any central agency.

In conclusion, I appreciate your invitation to express my views on the vital matters before you. I have done my best within the time limit that you mentioned in your letter of February 17, 1958, to Mr. Williams.

Sincerely,

Karl R. Bopp

Karl R. Bopp,
President

Enc.