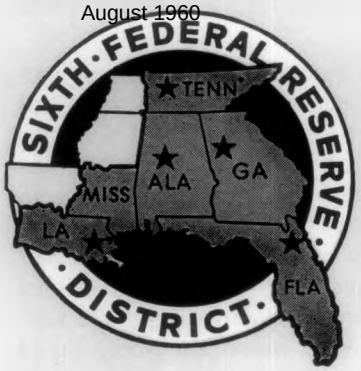


Monthly Review

Atlanta, Georgia
August • 1960

Also in this issue:

Federal Reserve Bank of Atlanta

Monetary Policy in a Changed Economic Environment

Who determines Federal Reserve monetary and credit policy? Part of the answer may be found in the Federal Reserve Act, which sets out formally the responsibilities and powers of the Board of Governors and the Boards of Directors and officers of the Federal Reserve Banks. Since all these are policy-making bodies to some extent, the men who serve as members of them make Federal Reserve policy. That is, they have the formal responsibility for determining policy—a responsibility they cannot escape.

Still, those men do not wholly "determine Federal Reserve policy," for in the American economic system all of us have some part in making monetary and credit policy. This is so because we are the ones who make the economic decisions to buy or to sell, to spend or to lend, to work or to play, and a host of others that create our economic environment. Since Federal Reserve policy must be adapted to this economic environment, the past and present decisions of American consumers, businessmen, and legislators all have a part in determining Federal Reserve policy.

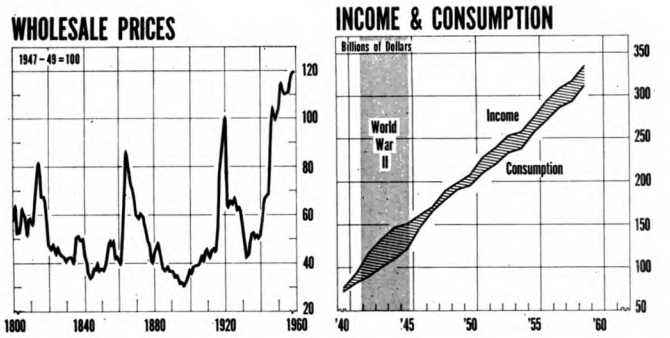
Policy must be adapted to changes in the economic environment because the function of the Federal Reserve System is "to make possible a flow of credit and money that will foster orderly economic growth and a stable dollar." The flow of credit and money that may be appropriate at one time, of course, may not be appropriate at another. Changes in the economic environment, therefore, clearly call for changes in Federal Reserve policy.

This can be seen from a review of economic and policy changes since the end of World War II. During most of this time, a persistent problem has been to devise policies that would help preserve the purchasing power of the dollar. Although there were three times during this period, in 1948-49, in 1953-54, and in 1957-58, when policies were designed specifically to offset recessionary tendencies in the economy, each time once recovery was again underway, policy-makers were faced with an inflationary economic environment. The charts on the next two pages and the discussion that follows show some of the reasons these inflationary pressures persisted.

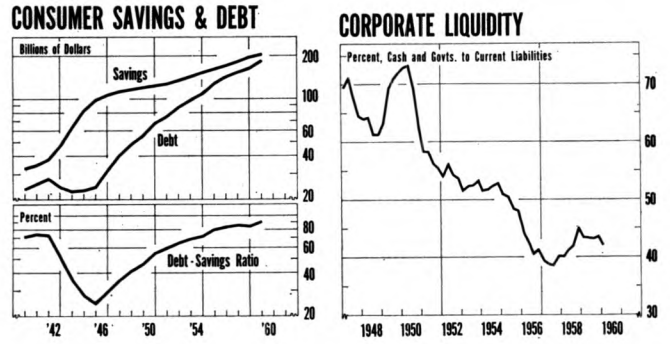
Desire to Spend and Ability to Pay

The inflationary pressures had their roots in World War II. Experience had shown that any country engaged in a major war is likely to have such pressures, which was one reason why price controls and rationing were started as soon as the United States got into the war. These helped keep spending down, but because incomes continued to increase, savings built up rapidly. In 1944, for example, current savings were 25 percent of disposable income, whereas before the war they had averaged about 4 percent. Meanwhile, consumers reduced their debts.

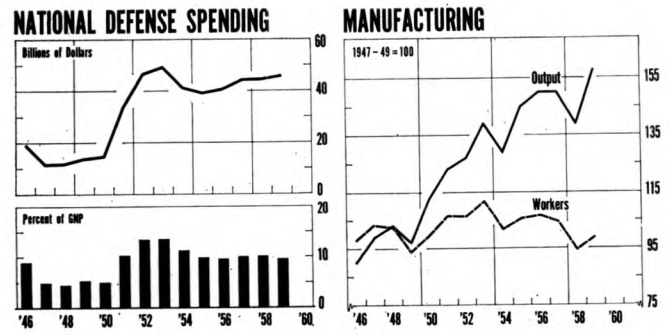
Thus, when controls were removed after the war ended, consumers could finance their spending by using their accumulated savings, by



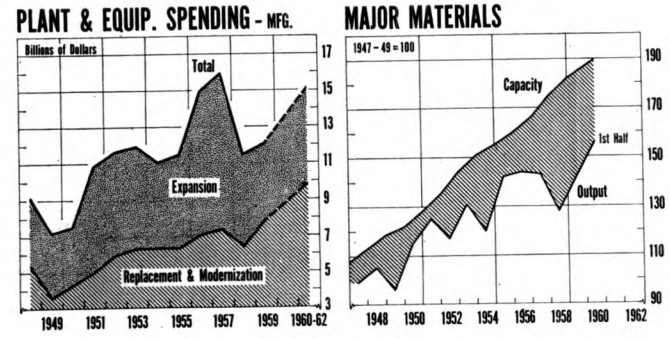
Prices did not rise rapidly during World War II as they did during previous wars because controls kept spending down, but once controls were removed, spending increased in relation to income, and prices advanced rapidly. Now, however, consumption in relation to income has assumed more normal proportions.



Both consumers and businesses accumulated large amounts of purchasing power during World War II and reduced their debts. In the early postwar years, therefore, they were able to spend and borrow heavily, but this extreme liquidity has gradually been reduced.



Because of the Korean War, national defense spending rose sharply in 1950-53 and brought additional inflationary pressures. Now, although still high, defense spending takes a smaller share of the Gross National Product. Also the ability of the economy to produce has expanded faster than the number of workers.



In a sellers' market through 1951, and less so through 1955, demands pressed severely against capacity, despite heavy capital spending for new or expanded manufacturing plants. Of late, as manufacturers seek to more fully utilize their enlarged productive capacity, there has been a gradual shift towards a buyers' market.

spending their current high incomes, and by going into debt. Because they had not been able to buy all the goods they wanted during the war, their accumulated demands were great and they called on all these sources of purchasing power. In this situation, rising prices did little to discourage consumer spending. Consumption spurted upward, until in 1947 it nearly equaled current income.

Corporations and other businesses and state and local governments also had postponed spending during the war. Consequently, corporations were in an extremely liquid position; their cash and government securities had built up to 70 percent of their current liabilities. Continued prosperity, moreover, enabled them to use internal funds to pay for a large part of the plant expansions that became necessary in the expanding economy. State and local governments used up surpluses built up during the war and borrowed heavily to fill the demands for increased public services. On top of all these domestic demands, other countries were clamoring for goods that only the United States could supply. Exports boomed.

No sooner had some of the pent-up demands been satisfied during the initial postwar period than the Korean War forced a sharp increase in defense spending, raising it from an average of 5 percent of the Gross National Product in the 1947-50 period to over 13 percent in 1952-53.

Looking at the entire postwar period, therefore, when peoples' wants, needs, and financial ability to pay for goods and services were so high, it is not surprising that demand increased tremendously. Since the supply of goods and services to satisfy the demand failed to rise correspondingly, it is also not surprising that prices surged upward.

Limits to Supply and Production

Increases in supply, of course, were limited by the economy's ability to increase production. Much of the manufacturing capacity created to fill wartime needs did not satisfy peacetime demands. Vast expansion programs were undertaken, therefore, to increase capacity, but until these new plants were ready for actual production, this program added to the demands for the nation's resources without increasing the supply of goods.

In this economic environment, Federal Reserve policy sought to hold demands within the capacity of the economy to supply them by moderating the growth in the money supply. The world's experience had shown that continuing inflation had never resulted in orderly economic growth. Thus, limiting, so far as possible, inflationary pressures would not only help achieve a stable dollar but would also foster economic growth. The Federal Reserve policy-makers' task then was to design policies that would help offset some of the effects of the powerful inflationary forces, an economic environment that was one of the heritages of World War II.

Except for use of selective controls and voluntary restraint, the aims of any policy adopted by the Federal Reserve System can be achieved only as it influences the availability and cost of bank credit by controlling member bank reserves. Consequently, although the Federal Reserve System could adopt policies designed to influence the growth in the money supply—demand deposits and cur-

rency—it could not directly influence the use of that money supply. Thus, in the postwar period demand pressures pushed toward a more active use of the money supply. In addition, activities of lenders helped increase spending. Consequently, the use of the money supply rose steadily as is indicated by the turnover of demand deposits.

With deposits high and loans relatively low in the earlier postwar years, commercial banks were both able and willing to increase their loans. They could convert their large government security holdings into higher yielding loans without loss so long as the wartime policy of supporting a fixed pattern of interest rates was continued by the Federal Reserve System. Mutual savings banks, insurance companies, and other institutional lenders who also had acquired large amounts of Government securities could sell them at par on a market supported by the Federal Reserve to make mortgages and other types of loans. Until interest rates were allowed to respond freely to the supply of and demand for funds, the effectiveness of any Federal Reserve policy was limited.

Although this situation was relieved by the Treasury-Federal Reserve Accord of 1951, when interest rates were allowed to perform their normal function, other inflationary pressures persisted. One of these pressures was the growing belief that a continued rise in prices was inevitable.

Inflationary Psychosis

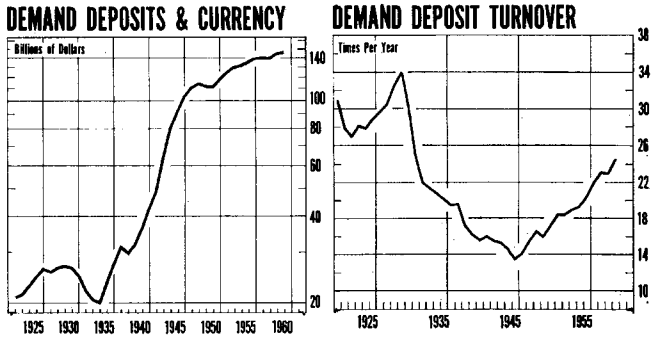
After losing a considerable part of the purchasing power of their savings by continued rises in prices, more and more persons during the later part of the postwar period began to try to protect themselves against future price increases. Thus, they reasoned, if prices were to rise indefinitely it seemed prudent to seek protection against inflation and to neglect some considerations that would be important under other circumstances.

Some persons sought protection by buying real estate without regard to current returns. Others who turned to the stock market were more interested in possible capital gains than in current yields. Such seeking of protection against future price rises influenced decisions on inventory and capital expenditures. Labor, seeking protection by way of escalator clauses tying wages to consumer price indexes, found the resistance of some businessmen weak because the latter believed they could pass on increased costs through higher prices.

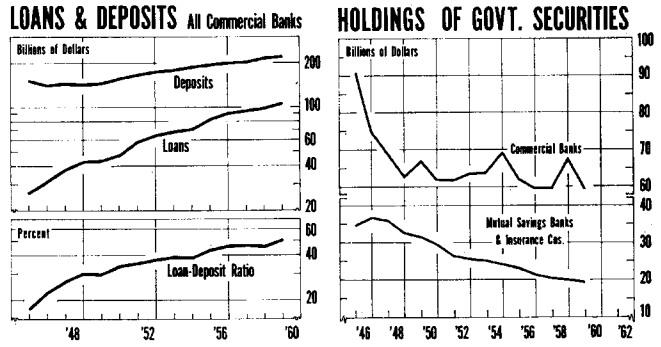
What was overlooked in this period was that the conditions generating price increases could be traced to a special set of demand and supply conditions. In this sort of

Sources for data used in the charts:

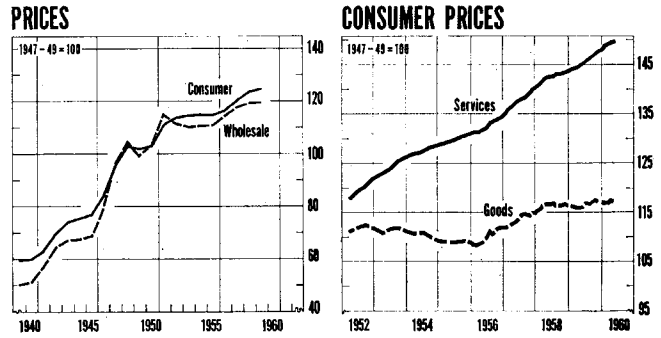
Consumer and Wholesale Prices: U.S. Dept. of Labor, Bureau of Labor Statistics.
Major Materials (Capacity and Output), Money Rates, Bank Loans, Deposits and Currency, Reserves and Borrowings: Board of Governors, Federal Reserve System.
Demand Deposit Turnover: Federal Reserve Bank of New York.
Manufacturing Output and Workers: Output, Board of Governors; Workers, U.S. Dept. Labor, Bureau of Labor Statistics.
Consumer Savings and Debt: Savings based on data published by Federal Home Loan Bank Board; Debt—Board of Governors.
Personal Income, Consumption Expenditures, and National Defense Expenditures: U.S. Dept. of Commerce.
Plant and Equipment Spending: U.S. Dept. of Commerce and McGraw-Hill Publishing Co.
Holdings of Government Securities: U.S. Dept. of the Treasury.
Corporate Liquidity: Securities and Exchange Commission.



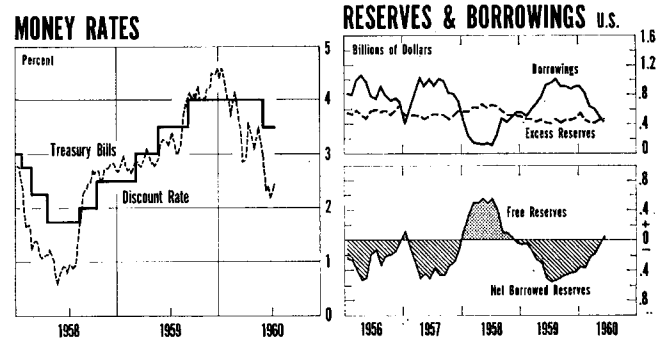
Inflationary pressures from the great expansion of the money supply during World War II were intensified by the increase in its use, measured by demand deposit turnover. With turnover now nearer pre-war levels, it may be more difficult to increase availability of credit by using the money supply more intensively.



With loans low relative to total deposits at the end of World War II, banks were able to increase loans sharply. They and other lenders could switch from low-yield Government security holdings to high-yield loans without loss until 1951, when interest rates were allowed to seek their own level. Now, bank lending may be more closely tied to reserve growth.



So far as the relative stability of average wholesale prices and prices for consumer goods since early 1958 has made the public lose faith in the inevitability of inflation and abandon actions influenced by the expectation of rising prices, to that extent inflationary pressures have been reduced.



Recently, short-term rates, as measured by yields on Treasury bills, have declined, a change recognized by the Federal Reserve Banks in reducing their discount rates. Member bank reserve positions have also eased partly because of lower required reserves resulting from deposit declines and partly because of reserves supplied by the Federal Reserve System through open market operations.

an economic environment, however, Federal Reserve policy had to give continued emphasis to preserving the value of the dollar.

A Changed Environment

Meanwhile, the economy was steadily changing and some of the inflationary forces were losing strength. Shifting our eyes from the left to the right of the charts on pages two and three, we see how great these changes were. As spending gradually became geared mainly to satisfying current demands, consumer income and consumption trends became more parallel, and consumer saving, the difference between the two, assumed a more normal relationship to income. Consumer debt rose year by year and is now at an all-time high, and thus its potential expansion has undoubtedly greatly decreased. Corporate liquidity has now been reduced to what is considered a more normal level. Although still high, national defense spending has decreased in relative importance to Gross National Product.

At the same time, the economy's capacity to produce the goods needed to satisfy demands has grown steadily; one measure of how much it has grown is the greater increase in output than in the number of production workers since 1953. Plant and equipment expansion has increased capacity to produce major materials not only in the United States but throughout the world.

Price developments reflect these changes. Average wholesale prices have changed little since 1958; the total index this year reflects near-stability in the prices of industrial commodities. Although prices consumers pay for services and rents have continued to move higher, prices of goods they buy have been stable, on an average, since early 1958. Prices now move up and down in response to current demand and supply situations, not to general inflationary pressures. Price competition is returning as more and more sellers try to attract buyers by means of offering attractive prices. One result is that an increasing part of the public apparently has lost its faith in the doctrine that inflation is inevitable.

With a great deal of excess liquidity squeezed out of the economy, with interest rates free to fluctuate, with the expansion of bank lending tied more closely to the availability of reserves, and with the investment policies of financial institutions geared more closely to the inflow of funds from savings, the economy has become more sensitive to monetary and credit policy changes. In this economic environment, less emphasis may need to be given to policies designed to limit inflationary pressures. The easing of credit so far this year, reflected in lower short-term money rates and easier reserve positions of member banks, reflects changes in the economic environment.

Has the economic environment changed so much that the money supply is no longer excessive as it was in most of the postwar period? He who would give a firm answer to this question at this point would be foolhardy indeed. But if the answer is Yes, monetary policies will reflect these changes as they have reflected changes in the economic environment in the past. Thus, he who would predict Federal Reserve policy must predict economic changes, changes that in large part reflect how Americans manage their economic affairs.

CHARLES T. TAYLOR

Florida's Economy

Good but Not Boomy

Many outward signs indicate that Florida's economy is operating in high gear. Total output, employment, and income are at or near record highs. Yet some people in this growth-conscious state are obviously disappointed with the pace of economic activity. In June this year, employment, the most comprehensive current measure of activity in the state, was barely above the level of last fall. Expansion in income and spending has also slowed, and competition for the consumer's dollar is keen. Construction activity, an important source of income, is off for the state as a whole, and in some areas is in the doldrums. It is no wonder, then, that some Floridians who have taken rapid growth in the state's economy for granted are now looking anxiously at past and present trends for clues to the future.

Expansion in Employment, Income, and Spending Slackens

Total nonfarm employment picked up during the second quarter this year, after edging down since last summer. Employment gains in the first half of this year, however, were smaller than in the comparable period of 1959 in both manufacturing and nonmanufacturing. Within the latter, which ordinarily accounts for about 85 percent of all persons at work in the state, the failure of employment in such important areas as trade, services, and construction to match 1959's pace limited employment gains. Construction employment in particular has been weak, declining 12.2 percent from December 1959 through June 1960, much more than seasonally. This decline compares with one of only 0.3 percent in the same period a year ago.

The declining rate of increase in total employment may have been accompanied by a reduction in the rate of income growth. Factory payrolls have risen only 4.8 percent since the end of 1959, compared with a gain of about 12.8 percent in the same period a year earlier. Since employment is increasing more slowly, it is probable that total earnings of nonmanufacturing workers are also rising less rapidly. Nevertheless, income gains in the nonfarm area, although they may be more difficult to come by, are