Monthly Review

FEDERAL RESERVE BANK OF SAN FRANCISCO

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MONETARY POLICY

. . . IN A BOOM PERIOD

A number of terms have been used to characterize the present state of the economy—inflation, prosperity, full employment, boom. All of these are useful and reasonably descriptive, but perhaps the last one is the most meaningful. "Inflation," in the sense of a general tendency towards rising prices, has been present during the past 18 months or so but on a much more moderate scale than during the early postwar period or even the Korean War period. The present situation is basically very different from that of 1946-48 or that of 1950-51. The terms "prosperity" and "full employment" (reasonably full, that is, since there is always a certain minimum amount of unemployment) are applicable to the present situation, but they have been applicable during most of the past decade and a half. During the past year or two, however, the economic picture has changed in a way that presents difficulties for monetary policy and that seems to call for a special term. The word that economists and the lay public alike have frequently used for a situation like the present is "boom."

The nature of booms

An economic boom is the usual last phase of a major upswing of the business cycle. History shows that those long periods of sustained prosperity which have ended in sharp depressions have been characterized by an element of overexuberance in their last phases. Not having experienced serious economic difficulties for a long time, people become unduly optimistic and imagine that prosperity will continue indefinitely. Although past business depressions are not entirely forgotten, it is widely believed that this time things are different. The over-confidence of businessmen, investors, bankers, government officials, and others may lead them to take actions which they would not take under normal conditions and which may not be in either their own personal interest or the general interest of the nation.

The average boom has a number of typical economic characteristics. Corporate stocks and real estate become the objects of widespread speculation and their prices soar. Private indebtedness rises sharply. New investment increases at an exceptionally rapid pace. At the same time, people become less prudent about the kinds of investment they make. During the booms of the nineteenth century, for instance, railroad lines and entire towns were built in uninhabited areas where there was no need for them. During the 1920's, according to studies made by the National Bureau of Economic Research, the quality of foreign bonds and urban mortgages sold to the public tended to deteriorate as the boom progressed; and many people still have sad memories of the unsound ventures they engaged in then. A rise in the general price level is a common but not universal characteristic of boom periods; it did not occur during the late 1920's.

History also indicates that economic booms typically end in speculative crashes and that these are followed by business depressions. Why this occurs is not completely understood—indeed, what causes the business cycle as a whole is still the great unsolved problem of economics. But we do know something about how this occurs. If new investment proceeds too rapidly, productive capacity will outrun for a time the ability or desire of the public to purchase all the goods that can be produced. If new business enterprises are basically unsound, this fact may be concealed for a while but sooner or later it becomes apparent to even the most optimistic. If speculative prices rise to heights where they are obviously excessive, many speculators will try to sell and a crash occurs. If business firms and individuals borrow too much, they will reach the point eventually where they can borrow no more and this stimulus to sales will disappear.

Usually, these factors will make themselves felt at about the same time, each one inducing another, so that the effects are cumulative. If this occurs, people will be thrown out of work, business enterprises go bankrupt, expenditures are generally curtailed, and the economy tailspins into a depression.

Are crashes and depressions inevitable? Or is it possible, as many persons have maintained recently, that our economy can continue to grow steadily with only occasional minor setbacks such as we had in 1949 and 1954? Have "rolling adjustments" made cumulative downturns obsolete? Unfortunately, these questions cannot yet be answered definitely, but a great many economists are not convinced that the business cycle as we have known it in the past has been permanently eliminated. No doubt, we have made much progress in our understanding of and ability to deal with depressions when they occur. But it may also be true that the growing size, complexity, and wealth of our nation make the potential difficulties even more serious than heretofore. Moreover, it seems doubtful that counter-cyclical measures can be put into effect quickly enough to prevent at least a moderately serious depression from developing.

What seems reasonably certain, at any rate, is that the more a boom is allowed to get out of hand—that is, the higher prices go, the more widespread speculation becomes, the higher debt is allowed to pile up, the worse becomes the lack of balance between investment and consumption, the more normal standards of prudence are weakened—the greater is the likelihood that the boom will come to a sudden and disastrous end. The chances for prolonging a period of prosperity would seem to be best if the economy can be kept growing at a fairly steady pace, avoiding inflation, undue speculation, and other boom-period excesses.

Where we stand today

Whether or not the current period is basically similar to those great booms of the past that have ended in crashes and depressions is a question that each observer must answer for himself. But certainly many typical boom-period phenomena are present in the economy today. Among them the following may be particularly noted. (1) After several years of relative stability, the wholesale price index has risen more than 5 percent in the past year and a half. (2) Stock prices reached record levels in August, at which time they were nearly twice as high as three years ago and not far from the highest levels in history when measured relative to earnings and dividends. Similarly, urban real estate prices have shown a substantial increase in recent years, as home buyers are painfully aware. (3) Total bank loans outstanding, after rising 16.5 percent during 1955, increased another 7.8 percent during the first 11 months of 1956. (4) Business expenditures on new plant and equipment, which had amounted to $26.8 billion in 1954 and $28.7 billion in 1955, have been estimated at $35 billion for 1956 and at an annual rate of $38 billion for the first quarter of 1957. (5) Possibly the most significant evidence of boom conditions is the optimism that prevails concerning the future of business. This optimism is reflected, for instance, in numerous published forecasts of uninterrupted growth for the economy, in frequent assertions that the business cycle has been ironed out, and in the apparently widespread belief that "it can't happen again." While some persons take a more cautious view of our economic future, they seem to be a minority at present.

Economic forecasting has not yet reached the point where it is possible to predict confidently when the rising phase of the business cycle will give way to a downturn. Economists have tried to develop forecasting tools by studying past cycles and have found that there is a good deal of similarity among them. Thus, there is a fairly typical pattern of behavior around the upper turning point in the cycle, in the sense that certain sectors of the economy are usually affected quickly and others later.[1]

[1] See Geoffrey H. Moore, *Statistical Indicators of Cyclical Revivals and Recessions*, Occasional Paper 31 (New York: National Bureau of Economic Research, 1950).

Unfortunately, no actual cycle is ever exactly like the typical one, since the latter is an average of many real ones. Consequently, interpretation of the data is always difficult. For instance, the decline since February in the total value of building contracts awarded (on a seasonally adjusted basis) and the rise during the past year or so in the liabilities of business failures have been unfavorable signs at the present time, since these are typical precursors of a general downturn in business conditions. But other typical precursors, such as wholesale prices, new business incorporations, new orders for durable goods, length of the work-week, and stock prices have either been improving or fluctuating irregularly in recent months. About all that can be said at the present time, therefore, is that the evidence can be interpreted in different ways.

Monetary policy as an anti-cyclical weapon

The problem of how to smooth out the business cycle has probably received more attention from economists during the past quarter of a century than any other. Many different monetary, fiscal, and other sorts of measures have been proposed. Here we are interested only in those of a monetary nature, which, after having been somewhat out of fashion during the depression, are now enjoying a revival of popularity. In part this is due to the fact that monetary measures are not very effective after a depression is under way, since, while they can make money easier to obtain, they cannot force anyone to borrow more or to spend more if he is reluctant to do so. On the other hand, during an inflation it is always possible to restrict spending by tightening up sufficiently on the money supply. Consequently, it is generally agreed that the chief contribution monetary policy can make to the smoothing out of the business cycle is to help restrain inflationary pressures and boom-period excesses. A flexible monetary policy will also contribute directly to smoothing out the cycle by permitting demands which were postponed during the more feverish days of the boom to be met with bank credit as other demands became less intensive.

As is well known, the Federal Reserve System has taken a number of steps during the past two years to keep speculative and inflationary tendencies in check. Early in 1955, when it seemed that the stock market was developing an unhealthy speculative fervor, margin requirements for the purchase of stock were increased twice. The rediscount rate has been raised six times since April 1955. Open market operations have been employed in such a way as to adapt the supply of credit to short-run changes in demand, while at the same time bank reserves have been kept from increasing as rapidly and persistently as the demand for bank loans, so that credit conditions gradually tightened.

The basic objective of these over-all monetary measures has been to restrain the use of bank credit for spending and thereby help to hold down the level of total expenditures to the level of total available supplies. If the public tries to buy more than can be produced, either of certain types of goods or of goods in general, prices will rise. To the extent that such buying is done with funds borrowed from the banks—and, of course, a considerable part of it is — restricting bank loans can operate to hold down the level of spending and therefore the rise in prices.

Some complaints have been voiced recently to the effect that monetary policy has been excessively restrictive. It has been argued that credit may be tightened up so much that business will be seriously hampered and the economy may be thrown into a depression. It will be desirable, therefore, to consider how restrictive our monetary policies actually have been and what effects this has had.

Any notion that the volume of bank credit has actually been reduced because of the actions of the Federal Reserve System is quite incorrect. Total loans of all commercial banks increased by 7.8 percent during the first 11 months of 1956, as compared with 13.9 percent during the same period of 1955. What has happened, therefore, is that after an abnormally large increase in bank lending during 1955 the rate of increase has been slowed somewhat. This is what one would expect and what sound monetary policy would dictate in view of the fact that the rate of growth of real output has also slowed down. This deceleration has been due partly to the July steel strike, partly to some slackening of demand for automobiles and certain other goods, but mainly to the fact that 1956 was not a year of recovery from recession with substantial unused resources that could be put back to work, as was the case in 1955.

There are at least three main types of expenditure that normally depend on bank credit to an important degree: home purchases, instalment buying, and inventory accumulation. In addition, when long-term funds are scarce, as at present, bank credit is used to a considerable extent in interim financing of plant and equipment expenditures. It will be worthwhile to examine these different types of spending, insofar as the data permit, to see how they have been affected by restrictions on bank lending.

Outstanding real estate loans by commercial banks increased 8.2 per cent during the first 11 months of 1956, as compared with 12.5 percent during the same period of 1955. Although total construction activity has been even higher this year than last, residential nonfarm construction has sagged. Even more serious than this has been the pronounced and fairly steady decline in new housing starts since the beginning of 1955. It is difficult to say how much of this decline is due to the shortage of mortgage funds and how much to higher construction costs or saturation of the housing market, but undoubtedly the former factor has been of some importance. However, the drop in residential construction has not resulted in much unemployment of resources since other types of construction have taken up most of the slack.

Total outstanding consumer credit extended by all commercial banks increased about 10.6 percent during the first eleven months of 1956, as compared with 19.3 percent during the same period of 1955. The increase in 1956, although smaller than the previous year's record increase, was thus considerable. The outstanding amount of every major type of consumer credit, including automobile loans, was larger in late 1956 than a year earlier. It seems fairly clear, therefore, that consumer purchases have not been greatly restricted by lack of credit. The fact that sales of automobiles and certain other types of consumer goods eased off last spring was more likely due to a temporary decline in demand.

No separate data are available giving the amount of bank credit extended for inventory accumulation, for plant and equipment expenditures, and for other types of business spending. However, total business loans by commercial banks increased by 13.3 percent during the first 11 months of 1956, as compared with about 20 percent in the corresponding period of 1955. Considering that last summer's steel strike probably held down bank lending somewhat and that the 1955 increase was much the largest on record, it seems clear that, taken as a whole, business has been far from starved for credit during the past year.

This view is confirmed by the very rapid increase in business expenditures on new plant and equipment and by the continued rise in inventories. New plant and equipment expenditures by business have been estimated at $35 billion during 1956 as compared with $28.7 billion during 1955. Inventories in manufacturing and trade rose $4.9 billion during the first ten months of 1956 as compared with $4.0 billion (seasonally adjusted figures) during the corresponding period of 1955. Not all of such expenditures are financed by bank credit, of course—indeed, the larger part of them are not. Nevertheless, bank credit has been used to finance an important and probably increasing part of such expenditure.

The conclusions that emerge from this brief survey are, first, that the high cost and limited availability of credit this year have probably restricted expenditures to only a small extent, except probably for new housing; and, second, that whatever restriction has occurred has been desirable (and desired) in that it has helped to reduce the inflationary pressures somewhat. There is little evidence that credit has been "excessively" restricted.

The increase in the money supply

If one considers only the quantity of money (demand deposits adjusted plus currency outside banks), it is possible to make a superficially plausible case for the argument that monetary restrictions have been excessive. During the first 11 months of 1956 the money supply increased only by about 1.2 percent, as compared with a 2.5 percent increase during the corresponding period of 1955 (seasonally adjusted data), and an average annual increase of 2.6 percent during the four complete years, 1952-55. Because of the less rapid rise in the money supply this year and also because it has failed to keep pace with the rise in output, it has been suggested by some that the money supply has not been allowed to increase as fast as it should.

This argument, however, ignores the fact that the total amount of spending that occurs depends not only on the volume of money in circulation but also on the rapidity of use of the money supply or the velocity of circulation. It is obvious that the more often the average dollar changes hands, the more work it can do in a year. Since 1954, this rate of use or turnover of the money supply has been steadily rising, reflecting the fact that business firms and individuals are holding fewer idle balances and are putting their funds to work more quickly. Thus, the income velocity of circulation (which is measured approximately by dividing the gross national product by the total money supply) increased from an annual rate of 2.99 in the third quarter of 1955 to 3.09 in the third quarter of 1956. This represents an increase in velocity of 3.2 percent, which should be considered along with the increase in the money supply of about 1 percent during the same period in analyzing the over-all monetary picture. The operation of these two factors has not only facilitated an increase in the real output of goods and services but also made possible a noticeable rise in the general price level.

Because of the importance of the velocity of circulation, it is impossible to say whether the money supply is increasing too rapidly or not rapidly enough simply by comparing its rate of increase with that of past years or with the increase in production or other economic variables. This question must be answered, rather, by observing whether the price level is rising or falling and whether business activity is booming or depressed. In short, the real test of the yeast is what it does to the bread. On this score it would certainly not seem that the rise in the money supply during recent months has been insufficient, particularly in view of the rising tendency of prices.

It is perhaps not surprising that some who have been squeezed by the tight credit situation should have difficulty understanding the need for such measures. The inconvenience to them is always clear and present; the danger to the economy is always distant and uncertain. Each producer knows that he could step up production or capital expansion if only he could obtain more credit but fails to realize that, when resources are fully utilized, he can do this only by bidding scarce resources away from others, thereby raising prices but not adding to total output.

While the individual producer may see the problem only from his own special point of view, it is, of course, the obligation of the monetary authorities to consider it from the viewpoint of the economy as a whole. Effective monetary policy thus requires that long-range and general objectives take precedence over short-range and special ones.

Needless to say, the monetary authorities also remain constantly alert to the danger that credit may be tightened up too much. There is always the possibility that a boom may prove to be basically different from preceding ones and therefore require different treatment. There are also the possibilities of misreading the evidence and exaggerating the strength of the boom or of failing to detect quickly changes in economic trends. While these possibilities exist and should be kept in mind, this article has indicated that so far there seems no reason to believe that any of them have materialized.

Restraining boom-period excesses and preventing depressions is not, of course, the exclusive responsibility of monetary policy. Fiscal policy and other types of government measures also have important roles to play, and it is essential that all of these measures be properly coordinated. This raises difficult problems that cannot be discussed here, but it may be stated simply that monetary policy is likely to be more effective if supported by the appropriate fiscal policy and other measures than if left to carry the ball alone.

1956 In Review

ADVANCES in national business activity in the closing months of 1956 insured that employment, income, and production would reach new yearly highs. The rate of growth during the year did not match that of 1955, however. Since 1956 began with the economy operating at a high level of activity, increases in the production of some basic nonagricultural commodities and many manufactured goods were limited to those made possible by additions to capacity during the year. Employment gains were restricted largely to labor force growth since the pool of unemployed persons was at a fairly low level even at the start of the year. Consequently, when business firms, consumers, and state and local governments increased their demands for goods and services, considerable upward pressure was placed on prices.

The changes in demand that sustained peak levels of economic activity in 1956 are somewhat different from those which brought a recovery and then a full-scale boom in 1955. Consumer spending for new residential housing and automobiles was substantially reduced in 1956. In fact, total expenditures for consumer durables declined during the year. The drop-off in consumer outlays for new automobiles was only partly offset by moderate increases in spending for household durables. Consumers continued to increase expenditures for nondurables and services over the year, although a larger proportion of the 1956 gain was accounted for by increasing prices than in 1955. The shift in consumer demand toward a larger volume of purchases of nondurable goods and services, which involve less reliance on time payments, led to a noticeable slowdown in the rate of growth of new instalment credit. Moreover, consumers chose to increase their rate of saving during the year.

Business spending rises

While consumer expenditures for durable goods declined, business spending on plant and equipment jumped sharply, from $29 billion in 1955 to about $35 billion in 1956. This large increase proved especially stimulating to the nation's heavy construction industry and to other industries manufacturing machinery, building materials, and fabricated metals. Another item of business spending that is usually highly volatile, additions to inventories, was smaller in 1956 than in 1955.

Government demand for goods and services rose in 1956 as state and local governments increased spending for educational purposes and highway construction. Expenditures by the Federal Government showed little change. The net effect of Federal Government fiscal operations, in fact, appears to have been mildly deflationary during the year as cash receipts from the public exceeded payments thereto. In 1955, receipts and payments to the public were nearly equal.

The increase in the total value of product from 1955 to 1956—an increase which preliminary estimates place at about $21 billion—is smaller than the 1954-55 gain of $30 billion. Moreover, only about half of the rise in 1956 represents an increase in actual physical output of goods and services. The remainder resulted from price increases. In 1955, price increases played a lesser role in the growth of gross national product.

Demand for credit outruns supply

The demand for credit persistently grew more rapidly than the supply during 1956. In response to conditions in the money markets, discount rates were raised during the year at the various Federal Reserve banks. The limited availability of credit caused some potential borrowers to do without funds, thereby limiting somewhat the demand for goods. Even so, according to preliminary estimates, total loans outstanding at all commercial banks in the United States rose about $6 billion from December 31, 1955 to November 28, 1956. Loans to business firms to finance expansion plans and additions to inventories accounted for a substantial part of the gain. Smaller increases occurred in real estate loans and consumer loans, while other categories either showed minor increases or declines. Commercial bank holdings of United States Government securities were reduced by about $3.5 billion in the first 11 months of 1956. In the same period, the money supply rose by about 1 percent, or only half as much as in the corresponding months of 1955. The increase in the velocity, or rate of use, of the money supply, however, was substantially larger than during 1955.

District business activity outpaces national rise

Twelfth District developments in 1956 generally paralleled those in the nation. While detailed estimates of consumer, business, and government spending within the District are not available, scattered sources of information suggest that business activity in the Twelfth District expanded at a greater rate than in the United States in 1956, as has been the case in most years since 1950.

Production indexes computed for the District are far less comprehensive than those for the nation, but it is nevertheless clear that the District output of goods and services increased more rapidly than in the country as a whole. Substantial increases in the District's labor force were made possible by a reduction in the average level of unemployment and by a sizable migration into the District, particularly into Arizona and California. Building permits issued for the construction of factories and commercial buildings through the first eight months of 1956 indicate that the growth in capacity of District industries proceeded at a rate substantially above that for the nation.

Total nonfarm employment in the District rose by more than 5 percent during 1956 as compared with a national gain of a little more than 2 percent. Reflecting enlarged levels of demand, employment expanded by 5 percent or more in manufacturing, construction, trade, finance, and government. More moderate gains were registered in mining and in the transportation, communication, and public utilities category. In the District, as in the nation, gains in total nonfarm employment during 1956 did not match those that occurred in 1955.

Durable goods manufacturing booms in the Twelfth District

Employment in nondurable manufacturing rose by 3 percent, but increased activity in durable goods accounted for most of the 6 percent gain in manufacturing employment in the Twelfth District in 1956. The most significant employment changes occurred in aircraft and parts and in ordnance. In fact, 50 percent of the total rise in manufacturing employment occurred in these industries. While the entire output of ordnance plants is for defense purposes, about 30 percent of the nation's backlog of orders for complete aircraft in September 1956 was for nonmilitary customers. The increase in activity in aircraft and ordnance, added to the record volume of heavy construction and increased business demands for durable equipment, enlarged the demand for the products of District metal and machinery industries, which had employment gains of 5 and 16 percent, respectively. Most of the growth in employment in the machinery industry was centered in firms producing electronic equipment. Other durable goods industries registered more moderate increases. A decline in the production of Douglas fir and western pine, engendered by the nationwide drop-off in residential housing construction, led to a 5 percent reduction in employment in lumber and wood products.

In nondurable manufacturing, employment rose 4 percent in food and kindred products and over 6 percent in printing and publishing. Most other nondurable goods industries registered more moderate gains. Textile and apparel manufacturing reported an employment decline of nearly 2 percent from year-ago levels.

A record year in construction

New construction activity in the District, based upon the value of building permits authorized, rose to a new high level in 1956. Through October the increase over the first ten months of 1955 amounted to 4 percent, smaller than the gain from 1954 to 1955 but larger than the increase in the nation during 1956. An increase of approximately 40 percent in the value of nonresidential permits more than offset a 15 percent decline in the value of residential authorizations. While residential construction has dipped further in the District than in the nation, gains registered in nonresidential categories greatly exceed those in the United States. Permits issued in the District for the construction of industrial and public utility buildings show the largest increases—more than 100 percent over 1956 levels. Major heavy construction contracts awarded during 1956 in the District included a $113 million steel mill at Fontana, California, a $40 million auto assembly plant in Los Angeles, a $45 million railroad trestle in Utah, a $44 million aluminum reduction plant in Oregon, a number of public utilities projects that totaled about $225 million, and a considerable quantity of commercial buildings, community buildings, and highway projects.

The decline in residential construction during 1956, in spite of high and rising levels of employment and personal disposable income, is attributed to a number of factors. In addition to the decreased availability of mortgage credit, it is generally believed that there may have been some decline in the basic demand for housing. Some District areas reported larger than usual inventories of unsold houses during 1956. Since the rate of new family formation has been declining in recent years, the demand for new houses has become more dependent on the growth of existing families who need bigger and better quarters. Many of these families have chosen to expand and modernize existing quarters rather than purchase a new house, since costs connected with building a new home, especially the cost of land, have risen. Furthermore, suburban areas now make new housing developments bear a larger share of the cost of installing new utilities and are increasingly restricting the number of units that may be built on a given land area.

Retail sales show marked changes from 1955

Consumer spending at retail establishments in the District (based upon data for stores operating from one to ten outlets) in the first nine months of the year rose by 5.5 percent over the same period a year ago. Preliminary indications are that sales during the fourth quarter continued at a level slightly higher than in the same quarter in 1955. At District department stores, cumulative sales for the year through November were 3 percent above sales for a comparable period a year earlier.

The increase in consumer expenditures in the District was not distributed evenly. Sales of establishments selling food, general merchandise, drugs, gasoline, and lumber and hardware show gains ranging from 12 to 22 percent. Sales of eating and drinking establishments and apparel stores rose by about 6 percent. On the other hand, District consumers chose to reduce expenditures for durable goods. Furniture and appliance sales registered a gain of nearly 5 percent, but sales of automotive establishments were down more than 9 percent in dollar value. Registrations of new automobiles in California through November dropped nearly 18 percent from a comparable period in 1955.

Bank credit expands with advances in business activity

Demands for bank credit remained strong throughout 1956, in line with the rise in business activity. Total loans outstanding at weekly reporting member banks in leading cities in the District increased $1.3 billion in the twelve-month period ending December 7, 1956, the same amount as in the year ending December 1, 1955.

Slightly more than half of the rise in loans during 1956 was accounted for by commercial and industrial firms. Large borrowings were made during the year by firms manufacturing lumber, metal, petroleum, and food and liquor products. Borrowings of wholesalers, retailers, and other commercial and industrial firms increased significantly also. A large decrease in indebtedness was reported for sales finance companies, largely because of the reduction in automobile sales. Public utilities and transportation firms, as well as textile and apparel manufacturers, reduced borrowings during the year.

Real estate loans, reflecting the high level of new construction activity, show a rise in 1956 of about the same amount as during the comparable period in 1955. "Other" loans—a category that includes loans to consumers—recorded a gain only one-third as great as in 1955, in line with the slowdown in the sale of consumer durables. Loans for purchasing and carrying securities, the smallest category, increased slightly during the past year.