BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

STATEMENT FOR THE PRESS

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Statement of the Board of Governors on proposals to maintain prices at fixed levels.

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March 6, 1939.

PROPOSALS TO MAINTAIN PRICES AT FIXED LEVELS

From time to time the Board of Governors of the Federal Reserve System is asked to give its opinion about proposals to require some agency of the Government to raise the general level of prices and then to keep it constant. Some would make it the duty of the Board to do this and some would create a new agency for the purpose. All would require that prices be controlled by regulating the amount and cost of money.

Those who favor such proposals believe that prices can be raised by increasing the supply of money, that prices can be lowered by reducing the supply of money, and that prices can be kept fairly steady by changing the supply of money in the right direction at the right time. They believe that, if prices were kept fairly steady, we would not have booms, depressions, and panics, business would run along on an even keel, and much suffering and hardship would be prevented.

The Board of Governors is in complete sympathy with the desire to prevent booms and depressions, and has always considered it its duty to do what it could to help accomplish these results.

Experience has shown, however, that (1) prices cannot be controlled by changes in the amount and cost of money; (2) the Board's control of the amount of money is not complete and cannot be made complete; (3) a steady average of prices does not necessarily result in lasting prosperity; and (4) a steady level of average prices is not nearly as important to the people as a fair relationship between the prices of the commodities which they produce and those which they must buy.

Steady prices and lasting prosperity cannot be brought about by action of the Federal Reserve System alone, because they are affected by many factors beyond the control of the Federal Reserve System.

1. Prices do not depend on money alone

Experience in recent years has shown that prices are not controlled by the amount or cost of money.

If currency alone is considered as money, the facts are clear and simple. There was $3,600,000,000 of currency in the hands of the public, outside the banks, in the middle of 1926 and about the same amount in the middle of 1929, while at the end of 1938 the amount of currency had increased to $5,700,000,000. If prices were governed by the amount of

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currency, prices would have been about the same in 1929 as in 1926 and would have increased sharply by the end of 1938. The facts are that the average of wholesale prices, expressed in an index number, was 100 in 1926, 95 in 1929, and 77 in 1938. From 1926 to 1929, there was no change in the amount of currency but there was a drop of 5 per cent in prices. From 1929 through 1938, there was an increase of 60 per cent in currency while there was a decrease of 20 per cent in prices. Evidently cash and prices do not move together.

It is easy to understand why the amount of currency does not control prices. Currency is not the principal means used by people in paying for what they buy. In fact, it is the small change of business. Most people keep only as much money in their pockets as they require for their day-to-day needs, such as car-fares, lunches, gasoline, and other items, and what they do not need they deposit at the banks. Business firms require currency to meet payrolls, stores to make change. Banks keep on hand only a reasonable supply to meet the demands of their customers and send the rest to the Federal Reserve banks.

Because of the way we have come to use our currency, chiefly for small payments, we cannot expect to raise prices or increase prosperity by the issuance of more currency either by the Treasury or by the Federal Reserve banks. Any surplus above the amount needed would only come back to the Reserve banks. People can always get all the currency they need so long as they have deposits to draw on.

But more than nine-tenths of the bills in this country are paid by checks drawn on bank deposits. Therefore the deposits that the public holds in banks and can use as a means of paying for what it buys, as well as the currency outside of banks, need to be considered as money. Again the facts show clearly that the volume of money does not control the price level.

The amount of demand deposits was $22,000,000,000 in June 1926, $23,000,000,000 in June 1929, and $26,000,000,000 at the end of 1938. As already stated, currency outside of banks was $3,600,000,000 in 1926 and in 1929, and $5,700,000,000 in 1938. The amount of money, therefore, was larger in 1929 than in 1926 and larger in 1938 than in 1929. But what happened to prices? In 1929 they were 5 per cent lower than in 1926; and in 1938 they were 23 per cent lower than in 1926. This proves that factors quite apart from the volume of money, i.e., of currency and deposits together were influencing the price level.

There have been times when the amount of money and prices have changed together; but usually they have not. When they have moved together this may have been due to the fact that it takes more money to do the same amount of business when prices are high than when they are low.

Whether prices and the volume of money do or do not move together depends on many other conditions, such as weather and the size of harvests, inventions, foreign trade, Government spending, taxes, wages, and the general attitude of business. When people are venturesome and expect

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good times, they lay in supplies and this tends to raise prices. When people are discouraged and expect things to go badly, they tighten their belts and buy as little as possible. The demand for goods declines and prices fall. Usually other things have a greater influence on prices than has the amount of money.

Neither do prices depend on the cost of money. This also has been shown by the experience of the last 10 years. The cost of money now is lower than it has ever been at any time for which we have a record. This is true not only of the rate at which the Government can borrow, and of the rate at which large corporations can get money in the money market, but also of the rate charged by banks to their regular customers. The average rate charged by banks in 36 cities on their business loans was around 5 per cent in 1926; it rose to over 6 per cent in 1929, and fell to 3-1/4 per cent in 1938. Federal Reserve discount rates in 1926 were 3-1/2 to 4 per cent; in 1929, 4-1/2 to 6 per cent. In 1938 rates were 1 to 1-1/2 per cent. During this period when the cost of money was so drastically cut, prices went down by about one-fourth.

In view of these facts the Board finds it impossible to believe that prices can be controlled by changes in the volume and cost of money.

2. Federal Reserve cannot completely control amount of money

The Federal Reserve System, furthermore, does not and cannot have complete control of the amount of money and its use. It has an influence on the amount and when other things are favorable this influence can become effective, but there are many occasions when the System's powers are limited.

As already explained, currency is not the most important item in our business life, and the Federal Reserve System supplies at all times the currency that the public demands. If the Reserve System should engage in so-called open-market operations, that is, if it should buy Government bonds, and if it should pay out Federal Reserve notes for them, as has been proposed in some of the bills before Congress, this currency would come right back to the Reserve banks and would serve no useful purpose.

The Federal Reserve System has more influence on the amount of deposits than it has on the amount of currency, but there are limits to the System's influence. The System has power to give the banks more reserves by buying Government bonds. The sellers would receive checks which they would deposit in their banks. The banks in turn would deposit these checks in the Federal Reserve banks, thus increasing their balances which under the law are the member banks' legal reserves.

At a time when things are going well and there is a demand for as much bank credit as the banks can supply, increasing the reserves of the banks will usually increase the amount that they are willing and able to lend or invest. As the banks lend or invest the money they can pass on

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to the public not only the amount of unused reserves that they have, but all the banks together can pass on several times the amount of these reserves. This is because the banks are required to keep as reserves only a portion of their deposits. The proportions are different for different classes of banks; but, at the present time, all the banks together can lend or invest about six times as much as their reserves. (A detailed explanation of the way this works was given in the Board's Annual Report for 1936.)

When conditions are such that banks lend or invest all the money they can, the Reserve banks by buying $1,000,000 of Government securities can enable the banks to increase deposits held by the public by $6,000,000. Conditions, however, are not always such as to bring this about. They have not been so for a number of years. The Federal Reserve banks have bought more than $2,500,000,000 of Government securities. There has been a large inflow of gold from abroad, and the reserves of our banks have increased from about $2,700,000,000 in December 1933 to $9,000,000,000 in January 1939. Deposits of banks, however, have not increased in anything like the same proportion; because the banks have not found it possible to use all the reserves they held. At this time they have about $3,500,000,000 more reserves than the law requires and are not finding any way to use these reserves.

The Federal Reserve System can see to it that banks have enough reserves to make money available to commerce, industry, and agriculture at low rates; but it cannot make the commercial banks use these reserves, it cannot make the people borrow, and it cannot make the public spend the deposits that result when the banks do make loans and investments.

3. Steady prices do not assure prosperity

Even if the amount of money did determine prices and even if the Federal Reserve System could determine the amount of money, experience shows that steady prices would not necessarily mean prosperity.

It is true that violent changes in prices are harmful. A very rapid rise in prices results in speculation, in accumulation of inventories and in unsound undertakings, which later result in a collapse with falling prices, failing business, and general distress.

But that does not mean that lasting prosperity is assured when prices are steady. We had fairly steady prices from 1921 to 1929; but during that period there was developing a speculative situation which led to the collapse in 1929. It was during this period that billions of unsound foreign loans were made; that expensive and unsoundly financed apartment houses and office buildings were erected far beyond the needs of the people; that stock prices rose to fantastic levels. It was during this period that the ground was prepared for the depression which began in 1929 and from which we have not yet completely emerged. An unchanged average of wholesale prices alone, therefore, does not assure the people of lasting prosperity. While prices are stable, destructive forces may be at work that

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lead to panic and disaster. To require the Board to be guided in its policies entirely or principally by changes in the level of prices would prevent it at times from doing its best to serve the public interest.

4. Relations of prices more important than average prices

One reason why steady average prices do not assure prosperity is that the average can be steady while prices of some of the commodities that make it up change violently. People are more interested in the relation between the prices of what they produce and sell and the prices of what they buy and use than in the general price level. A farmer is interested not only in what he can get for his products over and above the cost of production but also in what he has to pay for the things that he needs to buy - how many bushels of wheat or pounds of cotton it takes to get a suit of clothes or a new plow. For the industrial producer the cost of his raw materials and labor compared with the prices that his products will fetch is what counts. To a wage earner or salaried man the important thing is the relation between his income and the cost of living. Even the ability of people to pay their debts does not depend so much on the average level of prices as upon the amount by which their net income exceeds their living expenses.

A steady average of prices, furthermore, may cover up sharp movements in prices of important commodities upon which large sections of the country depend. For example, from March to September 1937, while the average of wholesale prices was steady, grains declined by 19 per cent and cotton by 38 per cent. Many people are misled by averages. At the present time, with the average of all wholesale prices at 77 per cent of the 1926 level, prices of farm products are at only 67 per cent, while industrial commodities are at 80 per cent. Even prices of different farm products differ widely. Cotton and grain prices are 50 per cent of the 1926 level, while livestock prices are 80 per cent.

An attempt to maintain a steady average of prices would run into serious difficulty in years when prices of some commodities were forced up by drought, armament demand, or other things beyond the control of the monetary authority. When prices of industrial materials advanced in 1936-1937, a steady average of prices could have been maintained only if prices of finished products had declined, and if that had occurred, it would have made it unprofitable to buy materials on a rising market with the prospect of selling finished products on a falling market. This would have resulted in a slowing down of industrial and building activity. Differences between price movements of raw materials and finished products were, in fact, an important reason of the turn down in business in 1937.

Summary

To summarize, the Board of Governors is in complete sympathy with the real purpose of the price-stabilizing bills, which is to prevent booms and depressions and have business always on an even keel. But experience has shown that prices do not depend primarily on the volume or the cost of money;

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that the Board's control over the volume of money is not and cannot be made complete; and that steady average prices, even if obtainable by official action, would not assure lasting prosperity. The Board exerts all its powers to provide a constant and ample flow of money at reasonable rates to meet the needs of commerce, industry, and agriculture. In order to maintain a lasting prosperity many other agencies of the Government, as well as many groups in the general public, must cooperate, since policies in respect to taxation, expenditures, lending, foreign trade, agriculture, and labor all influence business conditions.

The Board believes that an order by Congress to the Board or to any other agency of Congress to bring about and maintain a given average of prices would not assist but would hinder efforts to stabilize business conditions. It would hinder, because the price average frequently would indicate a policy that would work against rather than for stability. Such an order would also raise in the public mind hopes and expectations that could not be realized.

Conclusion

In view of all these considerations the Board does not favor the enactment of any bill based on the assumption that the Federal Reserve System or any other agency of the Government can control the volume of money and credit and thereby raise the price level to a prescribed point and maintain it there.

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