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CREDIT AND OUR ECONOMY

The Federal Reserve System has been in existence exactly twenty-five years and yet comparatively few people know what the Federal Reserve System really is, and still fewer know how it operates or the purpose for which it was created by Congress in 1913. May I, therefore, begin with a brief description of the general structure of the Federal Reserve System as the basis for my discussion on Credit and Our Economy.

In the first place, the Federal Reserve System differs from many of these other instrumentalities and agencies in that it is only in part a governmental institution. The member banks of the Federal Reserve System--about 6,300 in number--are privately owned and privately managed corporations in all parts of the United States. They are such banks as you keep your checking accounts with. Many of them were in operations long before the Federal Reserve System was organized. These banks that are members of the System are in competition not only with one another but with other banks that do not belong to the System. There are, in fact, more banks outside the Federal Reserve System than there are belonging to it, but the nonmembers, as we call them, though very numerous are relatively small. Around 80 or 85 percent of the banking business of the country is done within the Federal Reserve System.

The country is divided into Federal Reserve districts and each member bank deals with the Federal Reserve bank in its district. It owns stock in its Federal Reserve bank in proportion to its own capital and surplus and it maintains its required reserves with its Federal Reserve bank. The twelve Federal Reserve banks perform many services for their member banks and for the public, particularly in providing currency for circulation and in facilitating the clearance and collection of checks. The Federal Reserve banks also act as fiscal agents of the United States government. They carry the checking accounts of the United States government and do the servicing of the public debt. This means handling subscriptions for issues of government securities, paying interest, redeeming matured issues, making conversions and such things.

The twelve Federal Reserve banks are regional institutions. Each of them has a board of directors, representing not only the banking interests of the district but its agricultural, industrial and commercial interests as well.

Coordination of the activities of the twelve Federal Reserve banks is effected through the Board of Governors in Washington. The Board consists of seven members appointed by the President of the United States with the consent of the Senate. The Board, beside coordinating and supervising the operations of the Federal Reserve banks, has important regulatory powers as the administrative head of the whole System.

The members of the Board together with five representatives chosen by the twelve Federal Reserve banks constitute the Federal Open Market Committee. This committee directs the open market operations of the Federal Reserve banks, which I shall explain later.

Under the law, there are certain powers exercised directly by the Federal Reserve banks, there are certain ones exercised by the Board of Governors, and there are certain ones exercised by the Federal Open Market Committee. For the sake of simplicity, I shall simply use the term "Federal Reserve authorities" in speaking of the powers exercised under the Federal Reserve Act.

In order that they may perform their duties properly, the Federal Reserve authorities require all the accurate information they can procure as to the state of banking and business not only in the United States but in the world at large. Such information as relates to banking is secured from examination reports and from reports of condition which member banks themselves submit to the Reserve authorities. Much of the essential financial information required is reflected in the operations of the Federal Reserve banks, for no important monetary trend can fail to manifest itself in one or more of the general accounts on the books of the Federal Reserve banks. Certain financial movements will be reflected in increases and decreases in the volume of the bank reserves which constitute the deposits of the Federal Reserve banks. Certain financial movements will be reflected in increases and decreases in the amount of Federal Reserve notes in circulation. Certain movements will be reflected in increases and decreases in the volume of Federal Reserve bank loans and investments. Close observation and analysis of changes in Federal Reserve bank statements will consequently yield important information as to monetary conditions in general.

From sources outside the Federal Reserve System, the Federal Reserve authorities draw information as to industrial and economic production, prices, international trade and exchange, domestic trade, pay rolls, and employment. Most of this information is procured in cooperation with other agencies.

Although the Federal Reserve authorities make every reasonable effort to procure such information as will guide them in determining monetary policy, it goes without saying that there are many facts about economic life that are inaccessible. Nobody knows how much money is going to be spent by purchasers at next Christmas time; nobody knows what the prices of commodities are going to be six months from now; nobody knows exactly how many people are out of jobs at this moment. With respect to all such conditions, approximate and generalized information is the best that can be procured. Moreover, after the information is procured, it is not always possible to determine readily and exactly what course of action it calls for. The parts of our economic life are so closely interrelated and the factors determining it are so numerous that the unexpected is always happening. Employment influences production and production influences employment. Demand influences supply and supply influences demand. Political and international conditions affect business and business affects political and international conditions. Causes and effects are interwoven with one another so that the effect produced by one cause becomes itself the cause of other effects.

Bearing in mind these easily recognizable difficulties in the way of interpreting current information so as to determine the proper policy, you will be able to understand under what conditions the Federal Reserve authorities exercise the powers that I now wish briefly to describe.

The first of these is the power to conduct open market operations, which I have already referred to. Open market operations enable the Federal Reserve authorities by the purchase of securities in the open market to supply banks and the money market in general with additional reserve funds. Such purchases will be undertaken for the specific purpose of preventing tightness in the money market. At times such operations may be called for in order to increase the available supply of credit; at other times they may be called for merely to maintain a stable condition. In a broad sense, the mechanism of these actions is very simple. When investment securities are sold to the Federal Reserve banks, the money paid for them by the Federal Reserve banks naturally increase the funds available to the public.

On the other hand, when and if it appears that the volume of credit is excessive, the Reserve authorities may by the sale of securities withdraw from the market some at least of the excess. This results simply because the funds with which the securities are paid for when the Federal Reserve bank sells them disappear from the banks and the money market as they pass to the Federal Reserve banks.

In recent years the effectiveness of open market operations has been greatly circumscribed by the enormous accumulation of excess reserves of member banks. These excess reserves in turn have resulted from the movement of gold into the United States. Prior to the year 1934, the stock of monetary gold in the United States had never amounted to much more than four and one-half billion dollars. At the present time, it is more than 14 billion dollars. Over 3 billions of this increase is accounted for by revaluation, but a large part - perhaps the larger part - has come to the United States largely because of disturbed political and economic conditions elsewhere in the world. It has taken refuge here. It did not come because it was needed and it so far exceeds the requirements of the economic life of our people as to create a serious problem. More than one half of the monetary gold in the world is now in our possession. We have far more than we need and other countries have less than they need.

The effectiveness of any action that the Federal Reserve authorities may take is conditioned by the presence of these enormous reserves. Member banks now have reserve balances with the Federal Reserve banks of 9 billion dollars. Of this about 5 and one-half billions represent required reserves and 3 and one-half represent excess reserves. Purchases of securities by the Federal Reserve banks tend to maintain or increase this excess. On the other hand, since the Federal Reserve banks own only about 2 and one-half billion of securities, it is obvious that if they sold the whole amount it would no where near absorb the excess.

Another important power of the Reserve authorities is that of discount. When a member bank needs additional reserve funds it may borrow them from its Federal Reserve bank. There have been times in the past when member banks borrowed very heavily from the Federal Reserve banks, but under present conditions, as I have just described them, member banks in general have such a large volume of excess reserves that there is little occasion for them to borrow.

At times when there is an active demand for credit, the power of the Federal Reserve authorities to set the discount rate may be of considerable importance; a higher or lower rate will, of course, tend to influence

the amount of borrowing. In recent years, the discount rates of the Federal Reserve banks have been extremely low. At present they range from 1 to 2 per cent. These are the rates at which member banks may borrow from the Federal Reserve banks; they are not, you understand, rates on borrowing in general.

The monetary policies of the Federal Reserve authorities are one of many important factors which help to make any given business situation what it is. Not one of these factors can be neglected; not one of them can be depended upon to accomplish all that is desired. In recent years, the Federal Reserve authorities have pursued what is called an easy money policy. They have endeavored to maintain such credit conditions as would be most favorable for active business and increased employment.

When one speaks of credit, one must speak of the Federal Reserve System and its relation to the credit of the country. This, no doubt, is evident at this point of my discussion.

The economic prospects, so far as we can see them, are reasonably encouraging at the present time. A year ago activity in prices had been declining for several months, but we had not reached the end of the decline. Quite naturally, therefore, many people were wondering whether the decline was to be another long depression like the one which began in 1929. Now, however, we have seen not only a slowing down in the decline during the first half of 1938, but a sharp advance in the business situation generally during the second half of this year.

The total income payments are about the same now as they were at the end of 1937. The decline in payrolls from a year ago is narrowing, but work relief is higher.

In industrial production, the November adjusted index shows 103 per cent of the 1923-25 average and December will very likely be higher. The same index a year ago for the month of December was 88. This, of course, is an encouraging sign. There was during 1938 less decline in nondurable manufactures such as textiles and shoes than in durable goods, and their output has been above 1937 in the past few months. Output of durable goods such as steel and automobiles has been lower for the year to date but has shown sharp recovery in recent months and is now currently in excess of the same time in 1937. Steel output for the current week is 52 per cent of capacity and the average so far in December is 57 per cent as compared with 27 in the corresponding period of last year. Automobile assemblies are now around 100,000 a week and they were about 85,000 during the first part of December of 1937. There is, of course, a smaller output of minerals which did not decline much until after the end of 1937.

In building construction there has been a sharp reversal in movements during the past year. Residential building was declining in the latter part of 1937 and with incomes being reduced, many thought there would be a further reduction in 1938, but instead with prices of materials reduced and down payments and current financing charges materially lowered early in 1938 by amendments to the Federal Housing Act, there was a more than seasonal increase in the Spring and currently contracts for private work of this type were double those of a year ago. Also, contracts on projects

of the United States Housing authority are now being awarded in increasing volume.

Nonresidential construction shows a marked rise in public works contracts. By December 16th work was started on PWA projects to cost 1 billion 200 million dollars and to be substantially completed by July, 1940. A large part, but of course not all of this, represents an increase over a year ago when many of the projects started under earlier programs were being completed. There is, however, a continued low level of contracts for factories, commercial building, and other private non-residential building.

In domestic retail trade, there was little decline until the end of 1937, except for automobiles and house furnishings and the current level in most lines is about the same as a year ago. There was considerable decline in the first half of 1938 which was followed by an advance. Department stores' sales by dollar volume have been slightly smaller than a year ago with prices somewhat lower, but indications are that the December figures will be close to, if not equal to, that of the 1937 month. Mail order sales and sales at Variety Stores are about the same as at the end of 1937, but retail automobile sales in the month of November of 1938 are above the sales of a year ago.

In foreign trade, during the month of October, the exports on a value basis were lower than a year ago by about one-sixth and imports were lower than a year ago by about a fifth. Export trade decline is less than anticipated in some quarters and import decline stopped soon after industrial recovery in this country began in 1938. Excess of exports is still unusually large and is around 100 million dollars per month.

Inventories of consumers' goods lowered considerably by the middle of 1938, after a long period with trade reduced only moderately, while production was sharply curtailed. Inventories in other lines are also reduced and improvement in the inventory position generally contributed much to the rise in orders and activity in the middle of 1938. Currently stocks are substantially lower than at the end of 1937, but information is not available to indicate just how much they are below the end of 1937. At department stores dollar volume of stocks is about 10 per cent smaller than a year ago.

Commodity prices in general are moderately lower than a year ago and the index is 77 per cent of the 1926 average as against 83 per cent in 1937. There was a decline in commodity prices in the early part of 1938 and since May there has been little change in the general index. Some industrial materials currently are about the same as a year ago after a marked rise in the middle of this year. Agricultural products are lower than a year ago owing partly to increased carryovers, ample crops and also owing to increased supplies of live stock and dairy products.

Including Government payments, farm income is estimated at 7 billion, 625 million dollars for the calendar year 1938. This is down by one billion dollars from 1937, which was the highest since 1929.

On the whole, therefore, there are signs of improvement. Of course, I do not wish to darken the picture by going over the things which must prevent us from being too optimistic. You know well enough just what they are, but I should like to emphasize the fact that just as the Federal Reserve authorities cannot lay claim to having brought about the improvement mentioned through their sole effort, so also they can give no assurance that their policies only will make this improvement continue. Within the province of monetary matters, the Federal Reserve authorities have as their objective to maintain as favorable conditions as they can and business need feel no fear that sound and healthy activity will find any lack of the bank credit necessary to support it.