

Comments by
WILBUR D. FULTON, PRESIDENT
FEDERAL RESERVE BANK OF CLEVELAND

in response to the questions of
THE SENATE FINANCE COMMITTEE

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Foreword

The material in this report constitutes my comments in response to the seventeen questions submitted by Senator Harry F. Byrd as Chairman of the Senate Finance Committee, as of February 17, 1958.

The questions are not taken up in the order of their listing (see Appendix) but are considered under five general headings, as indicated in the table of contents.

To a considerable degree, these comments are an adaptation of a draft document which had been prepared through the collaboration of all twelve Federal Reserve Banks. Certain portions of this report, however, represent this bank's own contribution to the general subject. I wish to refer particularly to pages 3 to 19 which contain a graphic summarization of monetary policy since 1941. Also, on page 53 will be found a brief summary of my own judgment of the relative importance of price stability, maximum employment, and economic growth as objectives in the pursuit of the highest attainable rate of national growth and development.

Wilbur D. Fulton, President
Federal Reserve Bank of Cleveland

Part I. MONETARY POLICY SINCE 1941

(a). Graphic Summarization

Monetary history from 1942 to 1957 falls readily into eight successive phases, each of which differed quite significantly from its predecessor in terms of the prevailing economic environment.

The eight phases are discussed in chronological order in the following eight pairs of pages. On the left page there is indicated the type of monetary action which was theoretically appropriate in view of the concurrent behavior of average prices and of the general trend of economic activity. On the right page there is a review of the developments which actually occurred in the realm of monetary affairs.

It will be noted that the type of monetary policy suggested by the movement of prices was not always compatible with that suggested by contemporary trends in economic activity (production and employment).

Period Covered

Appropriate Monetary Policy suggested by:
Trend of PRICES Trend of ECONOMIC ACTIVITY

1942--mid-1945

RESTRAINT

RESTRAINT

(In the face of rapidly rising incomes, prices were relentlessly moving upward, either by reluctant sanction, or by threat of black markets.)

(Pressure of demand was almost continuously in excess of capacity to produce.)

1942

JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP	OCT	NOV	DEC

1943

JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP	OCT	NOV	DEC

1944

JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP	OCT	NOV	DEC

1945

JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP			

The Historical Record

Monetary restraint, however desirable theoretically throughout the war period, was almost totally foreclosed by the following announcement shortly after Pearl Harbor:

"The Federal Reserve System is prepared to use its powers to assure that an ample supply of funds is available at all times for financing the war effort, and to exert its influence toward maintaining conditions in the U. S. Government security market that are satisfactory from the standpoint of the Government's requirements."

In the face of the national emergency, a commitment of this type seemed almost inescapable. It proved unfortunate, however, that so large a part of the war's cost was financed by means of an inflationary expansion of bank credit.

Pursuant to the foregoing commitment, over the period the Federal Reserve System purchased \$19 billion of U. S. Government securities. It is true that most of this acquisition (\$18 billion) served merely to offset the concurrent drain on member bank reserves caused by the outflow of currency (into circulation) and gold. Nevertheless, in view of the \$3½ billion excess reserves already in existence at the time of Pearl Harbor, combined with some further additions of new central bank credit during the war, member banks were able to expand their holdings of U. S. Government securities by nearly \$53 billion. Accordingly, the nation's money supply (checking account balances and currency) more than doubled during the 3½ year period.

Period Covered

Appropriate Monetary Policy suggested by:
Trend of PRICES Trend of ECONOMIC ACTIVITY

Mid 1945--Mid 1946

RESTRAINT

(Prices rose sharply as war-accumulated purchasing power pushed against a continuing shortage of many civilian goods.)

EASE

(Considerable unemployment developed while readjustment to civilian economy was taking place.)

1945

			OCT	NOV	DEC

1946

JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG				

The Historical Record

In view of the subsequent boom it is a matter of some curiosity that bank credit expanded only very moderately during the reconversion phase. The expansion occurred in the form of bank loans (not investments), where a 10 percent expansion presumably expedited conversion to civilian production.

The wartime commitment regarding interest rates on U. S. Government securities presented no problem to the System during this 12-month period. Long-term money rates in particular reached record low levels without active intervention by the System. System purchases of U. S. Government securities (\$1.9 billion, net) were only enough to offset a concurrent further outflow of currency.

During this interval margin requirements on stock exchange collateral were increased in two steps from 50 percent to 100 percent. Also, somewhat later, the $\frac{1}{2}$ percent preferential discount rate on short-term Government securities was discontinued.

The Historical Record

The System was virtually powerless to counteract the inflationary potential of a \$4 billion influx of gold, because it was still committed to support the pattern of interest rates established in 1942. The money supply increased only moderately (albeit to a new all-time high), but a significant expansion (55 percent) occurred in bank loans. This active use of bank credit contributed greatly to inflationary pressures. Fortunately, (in view of the inflexibility of monetary policy) inflationary influences were being dampened by the continuously large cash surplus of the U. S. Treasury.

During this interval, the discount rate was raised from 1 percent to $1\frac{1}{2}$ percent in two steps. The System also was freed from the wartime commitment of having to peg the 91-day Treasury bill rate at $3/8$ percent. Likewise, war loan accounts (at member banks) were made subject to reserve requirements. Finally, the percentage of required legal reserves was raised by approximately \$3 billion by action of the Board of Governors. The potentially restrictive effect of this last named action was largely neutralized, however, by concurrent purchases of an almost equivalent quantity of U. S. Government securities.

The cost of money and credit did rise appreciably (from a low level) during this interval, but not enough to exercise any significant restraint on credit expansion. The Treasury surpluses exerted some restrictive influence, but the System itself was limited to fringe action by the pattern-of-rates commitment.

In terminating the 100 percent margin requirements in January 1947 (to 75 percent) after a sharp reaction in stock prices, the System recognized that the boom was no longer being supplemented by speculative activity in securities.

Period Covered

Appropriate Monetary Policy suggested by:
Trend of PRICES Trend of ECONOMIC ACTIVITY

Late 1948--Early 1950

EASE

(Average prices began to recede after mid 1948. By late 1949, wholesale commodity prices reached a two-year low.)

EASE

(The unemployment situation indicated the existence of considerable unused capacity and idle resources which might be activated by easier credit conditions.)

SEC					
1949					
JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP	OCT	NOV	DEC
1950					
JAN	FEB	MAR	APR	MAY	JUN

The Historical Record

In response to the softening of commodity prices and the diminished rate of industrial activity, the System pursued a policy of monetary ease throughout 1949.

The major move was represented by two series of reductions in the percentage of required reserves of all three classes of member banks, and covering time as well as demand deposits. The reduction in requirements was equivalent to the creation of nearly \$4 billion of excess reserves.

Since, in the absence of any contravening measures, that reduction could have become the base for an excessive expansion of the money supply, the System concurrently undertook to reduce its record-size portfolio of Government securities to the lowest level in the postwar period--in fact, since 1944. Enough liquidity was permitted to remain in the banking system, however, to accommodate a \$6 billion expansion in member bank holdings of U. S. Government securities.

Quantitatively, the supply of money did not change much on balance during 1949, but the cost of money declined noticeably, not only in the capital markets but also with respect to bank loans to business. The wartime commitment to support prices of U. S. Government securities presented no immediate problem while the bull market in such securities lasted.

The discount rate remained unchanged at the comparatively low level of $1\frac{1}{2}$ percent.

In March, margin requirements for stock exchange collateral were reduced to 50 percent (from 75 percent).

Period Covered

Appropriate Monetary Policy suggested by:
Trend of PRICES Trend of ECONOMIC ACTIVITY

Early 1950--Mid 1953

RESTRAINT

(A vigorous upthrust in prices was precipitated by the Korean War. The Consumer Price Index shortly broke into new high ground and was nudging upward during most of this 2½ year period, despite some retreat of wholesale prices from speculative peaks reached early in the War.)

RESTRAINT

(In terms of industrial production, recovery from the 1949 contraction was full and complete before the Korean invasion. Except for some months of hesitation during late '51 and early '52, there was no cushion of idle resources or capacity. Inflation of bank credit would merely accentuate the upward pressure on prices.)

1950					
JUL	AUG	SEP	OCT	NOV	DEC
1951					
JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP	OCT	NOV	DEC
1952					
JAN	FEB	MAR	APR	MAY	JUN
JUL	AUG	SEP	OCT	NOV	DEC
1953					
JAN	FEB	MAR	APR	MAY	JUN

The Historical Record

Upon the outbreak of the Korean War, the still-standing commitment to support Government security prices (which had been of only nominal significance in the recessionary year 1949) suddenly re-emerged as a roadblock to the application of effective monetary restraint against a surging inflationary wave. During the first eight months of the Korean outbreak, the System created \$6 billion of member bank reserves, in the course of purchasing Government securities from sellers who wished to obtain funds for other purposes.

During those eight months, the System had at its disposal (to combat inflation) only such measures as increasing the discount rate (to 1-3/4 percent), invoking controls over consumer instalment credit, and promulgating the new Regulation X to curb real estate credit expansion. Margin requirements were upped to 75 percent (from 50 percent). Reserve requirements also were increased \$2 billion (Jan. 1951).

All of these measures combined, however, were relatively powerless in the face of the rapid rate at which new central bank credits were being created. Fortunately, from the point of view of monetary management, a considerable portion of these credits were being offset by a strong outflow of gold.

Following the Accord between the Treasury and the Federal Reserve System (March 1951) credit policy was designed "to limit bank credit expansion to amounts consistent with the requirements of a growing economy at a high level without inflation."

The continuing demand for long-term capital as well as bank credit eventually pushed money rates to a 20-year high (May-June 1953). The discount rate had been upped to 2 percent in January of that year. In February, margin requirements were reduced to 50 percent since no substantial increase had occurred in the use of credit in the stock market.

Period Covered

Appropriate Monetary Policy suggested by:
Trend of PRICES Trend of ECONOMIC ACTIVITY

Mid 1953--late 1954

NEUTRALITY

(Prices did not decline but remained relatively stable--at virtually the all-time high.)

EASE

(Official end of hostilities in Korea was followed by a substantial cut in defense requirements. Readjustment from "war economy" was accompanied by contraction in employment and production.)

1953

					JUN
JUL	AUG	SEP	OCT	NOV	DEC
100.0000	100.0000	100.0000	100.0000	100.0000	100.0000
100.0000	100.0000	100.0000	100.0000	100.0000	100.0000
100.0000	100.0000	100.0000	100.0000	100.0000	100.0000

1954

JAN	FEB	MAR	APR	MAY	JUN
100.0000	100.0000	100.0000	100.0000	100.0000	100.0000
100.0000	100.0000	100.0000	100.0000	100.0000	100.0000
100.0000	100.0000	100.0000	100.0000	100.0000	100.0000
JUL	AUG	SEP	OCT	NOV	DEC
100.0000	100.0000	100.0000	100.0000	100.0000	100.0000
100.0000	100.0000	100.0000	100.0000	100.0000	100.0000
100.0000	100.0000	100.0000	100.0000	100.0000	100.0000

The Historical Record

Beginning in May 1953, the System embarked first on a policy of relieving the tension in the money markets and then of actively promoting credit ease.

Reserve requirements were reduced in July 1953 and again about a year later. The amount of excess reserves created in the two actions was estimated at \$2.8 billion. The striking consequence of the reductions was a record increase in the loans and investments of member banks. The \$16 billion expansion (in 18 months) caused the nation's money supply to expand by a record peacetime amount and induced a high degree of liquidity in the economy as a means of stimulating industrial recovery.

The cost of short-term money fell to a seven-year low in 1954. Early that year the discount rate was lowered in two steps to $1\frac{1}{2}$ percent (from 2 percent). The cost of long-term funds also declined to the lowest in several years.

Period Covered

Appropriate Monetary Policy suggested by:
Trend of PRICES Trend of ECONOMIC ACTIVITY

Late 1954 to late 1957

RESTRAINT

(Early in 1956, consumer prices began to break out on the upside into new all-time high ground. Wholesale prices had begun a renewed climb almost a year earlier.)

RESTRAINT

(By late 1954, the economy was back on an "overtime" basis. Many materials also seemed to be in short supply. Any undue expansion of the credit base would merely have aggravated the upward pressure in prices, and would not have resulted in any more employment or production.)



The Historical Record

Fairly early in 1955 it became the policy of the System to permit no further cyclical expansion of member bank reserves. Temporary additions for normal seasonal purposes were not allowed to become a permanent part of the credit base but were largely withdrawn after each need had passed.

As a consequence of this policy, the \$20 billion increase in member bank loans was financed largely by a concurrent liquidation of member bank holdings of U. S. Government securities-- at almost constantly declining prices. (Member banks also increased their borrowings somewhat in order to meet the extraordinary demand for business, instalment, real estate, and other loans.) Accordingly, the contemporary expansion in demand deposits was held to the smallest proportions recorded in any business boom for at least thirty years. Only the less-volatile time deposits expanded appreciably.

The continuing strong demand for credit and capital, in the face of a nearly static credit base, produced a steady rise in the cost of money. In order to keep the discount rate in reasonable relationship with open market money rates, the rate was increased from $1\frac{1}{2}$ percent to $3\frac{1}{2}$ percent in a series of steps beginning in April 1955 and ending in August 1957. Margin requirements against stock exchange collateral also were increased (from 50 percent to 70 percent) during the early months of this period.

COMMENT: If the System had capitulated to all of the pleas for "more credit," the boom presumably would have risen to greater and more untenable heights, and the ensuing readjustment might have been much more drastic and difficult.

The Historical Record

The complete history of the current period cannot be written until the next phase has taken over. Yet it may be recorded here that the System has used all three major instruments of general credit control for the purpose of mitigating recessionary tendencies and of establishing a sound base for a renewed expansion in industrial activity.

The discount rate was brought down in several stages from the long-time high of $3\frac{1}{2}$ percent, to $2\frac{1}{4}$ percent. Legal reserve requirements of member banks also were reduced by roughly \$1 billion. Meanwhile, purchases and sales of U. S. Government securities were of such a nature as to permit member banks to reduce their indebtedness to the reserve banks from a level of nearly \$1 billion (Sept.-Oct. 1957) to almost zero.

Changes in the supply of money have been somewhat slow in reflecting these several developments, but there has been a vigorous expansion in member bank "loans and investments" in recent weeks, with possibly much more to come as a result of the latest cut in reserve requirements.

The decline in the cost of money has been one of the sharpest on record.

Margin requirements on stock exchange collateral were reduced to 50 percent (from 70 percent) in January 1958.

The remainder of the historical record of this period will depend not only upon the course of economic activity and prices during the coming months, but also upon the extent to which the effects of actions already taken are yet to be felt in full.

PART I. MONETARY POLICY SINCE 1941
(b) Textual Description

The purpose of the following discussion is to review monetary policy since 1941 in somewhat greater detail than in the preceding pages, emphasizing the inflationary characteristic of the period as a whole as well as the relationship of monetary policy to the rise in prices.

Policy in Wartime

At the outbreak of war, the Board of Governors of the Federal Reserve System announced that the primary objective of the System during the war would be "to assure that an ample supply of funds is available at all times for financing the war effort and to exert its influence toward maintaining conditions in the . . . Government security market that are satisfactory from the standpoint of the Government's requirements."

Notwithstanding the urgency of the situation, and the need for a reassuring posture, the decision (to assure an ample supply of funds for war finance, and to finance the war at low and stable rates of interest) in effect relegated control of inflation to a position secondary to the objective of facilitating war finance. Inflationary forces, it was hoped could be kept within reasonable bounds by rationing, direct controls over prices, wages, and output, together with selective control of consumer credit. That this hope was substantially realized is indicated by the relatively mild increase (11 percent) in consumer prices between mid-1942, when the machinery of direct control was becoming effective, and the end of the war. The mere statistical increase in the price index, however, understates the degree of inflation, in view of the growth of black markets and the substitution of nonstandard and inferior products.

Two major operating policies were adopted early in 1942 pursuant to the System's wartime financial objective. They were: (1) an official commitment on the part of the Federal Reserve Banks to purchase all United States Treasury bills that might be offered at a rate of $\frac{3}{8}$ of 1 percent, coupled with an agreement to resell the bills to the vendor any time before maturity at the same rate; and (2) purchases in the open market to prevent yields on longer-term Government securities (certificates, notes, and bonds) from rising above predetermined levels. Successful implementation of these policies resulted in the establishment of a pattern of rates on Government securities, ranging from $\frac{3}{8}$ of 1 percent on 91-day Treasury bills to 2- $\frac{1}{2}$ percent on the longest-term bonds (at that time, 30-year maturity). To facilitate further the financing of the war, two additional operating policies were adopted. They were the establishment of a preferential discount rate of $\frac{1}{2}$ of 1 percent for advances secured by short-term Governments, and reductions in reserve requirements of central reserve city banks.

Once investors and other market participants became convinced that rates would not be permitted to rise above the levels selected early in the war, the attainment of the primary objective of monetary policy during the war was assured. In a sense, the maintenance of a low and stable structure of interest rates produced some highly desirable results: (1) it encouraged prompt buying of securities by investors, who might otherwise have awaited higher rates; (2) it assured a strong and steady market for outstanding securities; (3) it kept down the interest cost on a given volume of war debt; and (4) it limited the yield on bank and other investors' earnings on any given type of Treasury security.

Unfortunately, however, the failure to raise a greater proportion of the funds required for financing the war through taxes and sales of securities to genuine nonbank investors, and the resulting rapid expansion of bank credit and the money supply, contributed to inflationary pressures, both current and latent. Only 40 percent of the funds obtained to finance the war were raised through taxation. The War Loan drives, while appearing on the surface to have resulted in the sale of large amounts of securities to genuine nonbank investors, actually relied significantly on bank credit expansion for their success. After the Third War Loan, the Treasury offered nothing but short-term securities for subscription by commercial banks. Consequently, banks subscribed to the short-term securities, sold considerable amounts to the Reserve Banks, and then bought the longer bank-eligible securities in the market above par, thus permitting speculatively-inclined, nonbank subscribers to make quick profits and again subscribe to large amounts in the next Loan. In addition, the relatively low yields on bills and certificates exerted strong pressures on banks and other investors to liquidate these instruments (which the Federal Reserve had to purchase in order to maintain the rate pattern) using the funds thus acquired to purchase longer-term, higher-yielding securities. While most of the reserves supplied in this manner were absorbed by an increase in currency in circulation and an outflow of gold, a substantial volume was used to support the expansion of bank investments and, consequently, promoted inflationary growth of the money supply.

Although the shifting process could have been discouraged and perhaps eliminated by permitting short-term rates to rise relative to longer-term yields, Treasury officials were reluctant to agree to any breach of the rate pattern. Even though the shifting process gained

momentum in the later stages of the war and did not cease until about mid-1946, it was not until the summer of 1947 that yields on Treasury bills and certificates were permitted to move higher. In the meantime, the over-all technique of war finance and the resulting excessive monetary expansion, together with wartime shortages and accumulated demands, laid the basis for a sharp increase in prices of goods and services when price controls and rationing were suspended in 1946.

Postwar Policy up to the Accord

Throughout most of the period from mid-1946 until the consummation of the Treasury-Federal Reserve Accord in early 1951, Federal Reserve Authorities were confronted with the task of reconciling two conflicting responsibilities. Briefly stated, these responsibilities were, on the one hand, to utilize general instruments of credit control in an orthodox manner to restrain inflationary pressures and, on the other hand, to maintain stable and orderly conditions in the Government securities market.

The importance of the first responsibility is emphasized by the fact that from the beginning of the period until the latter part of 1948, and again in the latter part of 1950 and in early 1951, inflationary pressures were severe. In the earlier period, the pressures resulted primarily from the huge volume of liquid assets built up during the war and the accompanying shortages of goods and deferred demands. In the latter period, the outbreak of fighting in Korea, which followed closely upon recovery from the mild recession of 1948-1949, stimulated business and consumer spending in expectation of greatly expanded military expenditures and in fear of renewed shortages of goods. Under each of these circumstances, orthodox principles of central banking would have called for a restrictive credit policy. While some inflation was no doubt

inevitable in each instance, an effective restrictive policy would have limited inflation by reducing the attractiveness of liquidating Government securities in order to purchase goods and services or, in the case of banks and other financial institutions, in order to engage in credit extension to private borrowers at higher yields.

Adoption of an orthodox restrictive policy would, of course, have necessitated the abandonment of the policy of maintaining a stable market for Government securities. Flexible credit policies require flexible interest rates, which in turn mean that prices of debt instruments, including Government securities, must be free to fluctuate with market forces and those emanating from the actions of the central bank. So long as prices of Government securities were supported at relatively high prices, holders of the instruments had the opportunity of liquidating their Governments at attractive prices. In essence, the Federal Reserve acted as a passive buyer of Governments and, in the process, supplied additional reserves to the market on the initiative of holders of Government obligations.

There was, on the other hand, wide concern as to the probable effect of abandonment of par support on the market for existing Government securities, on the Treasury's refunding operations, and on the state of business in general. Such action, it was believed, might precipitate disorderly conditions in the Government securities market. Lower and fluctuating prices for Government securities would lead to complications in Treasury refunding operations, and higher interest rates would increase the cost to the Treasury of servicing the Federal debt. In the early postwar period, it was feared that abandonment of par support might precipitate a crisis in the security markets generally and interfere seriously with the reconversion and expansion of industry.

These latter arguments, while perhaps appearing less convincing today in view of the relative ease with which the par support program was finally terminated in 1951, were of considerable significance in the early postwar years. It should be recalled that at the time large amounts of Government securities were in the hands of financial institutions and other investors who had purchased the securities for patriotic and other reasons during the war, and who were anxious to liquidate the securities to obtain funds for other purposes. It is, therefore, quite possible that chaotic conditions in the market for Government securities would have developed had the System attempted to abandon the par support program much earlier.

In view of these considerations, the System attempted to reconcile the conflicting objectives by combatting inflation through actions that did not necessitate the abandonment of the support program. Thus despite purchases of \$10 billion of Treasury bonds in the twelve months ended October 1948, total Federal Reserve holdings of Government securities increased only \$1 billion (the \$1 billion of net purchases was more than offset by an increase in reserve requirements in September 1948). The difference of \$9 billion resulted partly from System sales of shorter-term Governments, which took place during the rise within the pattern of yields on these securities; another offset was the Treasury's program of debt retirement out of surplus funds, which was concentrated in maturing securities held by the Reserve Banks.

Other actions taken by the System to limit inflation included: (1) an increase in Reserve Bank discount rates from 1 to 1-1/4 percent in January 1948 and to 1-1/2 percent in August; (2) appeals to bankers to exercise caution in lending policies, to curtail speculative loans, and to guard against overextension of consumer credit (Regulation W was inoperative from November 1947 to November 1948); and (3) requests for

additional powers over member bank reserves, including authority to raise existing requirements to higher levels and to prescribe secondary reserve requirements for member banks. It is doubtful that these actions or proposals had much effect. The discount mechanism was in a state of disuse inasmuch as banks could easily adjust reserve positions cheaply and efficiently in the Government securities market. Appeals to bankers were ineffective in offsetting customer pressure and a strong profit pull toward private credit extension, not to mention the difficulty confronting bankers of distinguishing essential from nonessential credit demands. Requests for additional legislative authority received no action until the summer of 1948, when Congress renewed the authority for Regulation W and granted the Board of Governors temporary authority to raise member bank reserve requirements above existing statutory limits. The Board promptly raised reserve requirements and reinstated consumer credit control. As it turned out, inflationary pressures had begun to subside in the summer of 1948.

With the changed economic situation that became apparent in early 1949, System authorities took action to ease credit, including reductions in margin requirements, instalment credit terms, and member bank reserve requirements. However, concern regarding the rise of prices of Government securities led to substantial System sales between January and June 1949 as market demands for Governments increased. In late June, the Federal Open Market Committee announced that, after consultation with the Treasury, it had been decided that purchases, sales, and exchanges of Government securities would be undertaken with primary regard to the general business and credit situation. It was pointed out that the policy of maintaining orderly conditions in the Government securities

market would be continued but that, under conditions existing at the time "the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased." The statement was widely hailed as marking the return of the System to flexible monetary policies.

Support operations were again undertaken, however, following the outbreak of fighting in Korea in the summer of 1950. Although the System attempted to restore flexibility to monetary policy in August, when discount rates were raised, the Treasury opposed such action. The necessity for supporting Treasury refunding operations in August and during succeeding months forced the Federal Reserve to absorb large amounts of shorter-term securities and to support long-term bond prices. Banks, insurance companies, and other financial institutions began to liquidate Governments in large volume in order to obtain funds to support private credit extension. Later, other holders began to sell Governments, particularly longer-term issues, because of fear that their prices would later decline. In supporting the market, the Federal Reserve between August 1950 and the end of the year purchased \$8 billion of maturing Governments, \$1 billion of restricted bonds, and \$1.4 billion of short-term securities. Sales of short-term Governments in the amount of \$7 billion partially offset these purchases. In January 1951, as support purchases continued in large amount and as seasonal factors were adding substantially to bank reserves, member bank reserve requirements were increased.

It was clear that net System purchases were contributing to inflationary pressures by keeping interest rates low and credit readily available, and by adding to the reserves of the banking system. Loans of commercial banks increased \$7.5 billion during the latter half of 1950 alone.

Prices of goods and services rose rapidly, reflecting heavy buying by individuals and businesses in fear of war-induced shortages. Moreover, there was considerable public discussion of disagreement between the Treasury and the Federal Reserve. The need became imperative for an understanding between them which would permit the System to pursue flexible monetary policies suited to the general business and credit situation. The result was the Treasury-Federal Reserve Accord, announced jointly by the Secretary of the Treasury and the Chairman of the Board of Governors and of the Federal Open Market Committee on March 4, 1951.

The terms of the Accord, which provided the basis for restoration of flexible monetary policies, were as follows:

(1) In order to remove a substantial portion of the long-term Government bonds that were overhanging the market, the Treasury agreed to offer in exchange for certain long-term marketable issues a long-term, nonmarketable bond that would be convertible at the holder's option into a marketable Treasury note.

(2) The Open Market Committee pledged that it would, in effect, support the exchange operation by making limited purchases of any long-term bonds that private holders might try to sell after the terms of the exchange offering were announced. It was specified, however, that "the situation would be assessed daily," that "the market would be kept orderly," and that "open market purchases, if any, would be made on a scale-down of prices."

(3) It was agreed that in order to hold to a minimum the reserve-creating purchases of short-term Governments, the Federal Reserve "would immediately reduce or discontinue purchases of short-term securities and permit the short-term market to adjust to a position at which banks would depend upon borrowing at the Federal Reserve to make needed adjustments in their reserves." It was thought that this action would result in renewed use of the "discount window" as an avenue for obtaining Federal Reserve credit and, as a consequence, greater reliance on discount policy as a device of credit control. Short-term interest rates would, it was believed, tend to fluctuate around the discount rate. The Federal Reserve agreed, however, not to raise the discount rate (then 1-3/4 percent) during the remainder of 1951.

(4) Federal Reserve authorities pledged that their operations would be designed "to assure a satisfactory volume of exchanges in the refunding of maturing Treasury issues." The Open Market Committee would, in other words, support Treasury refunding operations to ease the readjustment.

The Federal Reserve continued to purchase substantial amounts of Treasury bonds for a short time following the Accord, but on a gradually declining scale of prices. Following the Accord, purchases of short-terms were promptly discontinued. Short-term rates, reflecting the termination of System purchases, rose sharply at first, but thereafter tended to move with market forces. Banks began to use the discount facility to adjust reserve positions. Under these conditions it was possible to pursue flexible monetary policies, even though support for Treasury financing operations was afforded from time to time until late 1952.

In evaluating Federal Reserve credit policies during the years 1946-1951, it is important to note that by far the larger portion of the early postwar inflation (in the period 1946-1948) occurred before the problem of par support became acute in late 1947. Between early 1946 and the end of 1948 consumer prices rose 32 percent. However, four fifths of the increase took place before the final quarter of 1947, reflecting the removal of direct controls in 1946, and it was not until late 1947 that the System began large-scale purchases of long-term Governments in order to support their prices. Thus most of the inflation that occurred in 1946-1948 resulted from earlier actions--namely, the manner in which the war was financed, and the resulting monetary expansion--and the huge accumulated demands for goods and services both here and abroad.

Nevertheless, hindsight supports the judgment that an earlier return to more flexible monetary policies would have been desirable.

Had it not been for the substantial Treasury surpluses in 1947 and 1948, totaling almost \$14 billion, and the use of a large portion of the surplus funds to retire maturing securities at the Federal Reserve Banks, control over the Reserve position of the banking system would have been still more difficult. The willingness of the System to monetize longer-term Government securities by creating Federal Reserve credit at relatively low rates of interest undoubtedly interfered greatly with efforts to restrain inflationary pressures. The success of the offsetting policies should not, however, be underestimated. Despite the support operations, the volume of bank credit and the money supply actually changed little in 1948.

Even more important is the judgment that failure to restore flexible monetary policies earlier in the postwar period led inevitably to reliance on support techniques following the outbreak of fighting in Korea. While much of the earlier postwar inflation was beyond the practicable influence of monetary policy, the same was less true in late 1950 and early 1951. The post-Korean inflation resulted not only from a more active use of the money supply as consumers and businesses rushed to buy in expectation of shortages and higher prices, but was also supported strongly by credit expansion. The credit expansion was facilitated by Federal Reserve creation of reserves as an adjunct to the support program.

Policy Since the Accord

Monetary policy during most of the period since the Accord has been directed primarily toward restraining inflation. Pressures on the supply of labor and other resources, arising from a high level of defense expenditures and strong consumption and investment demands (except for a brief period in 1953-54 and again recently), tended to push prices higher. Between mid-1951 and the end of 1957, consumer prices rose 10 percent, with more than half of the increase occurring in 1956 and 1957.

Balance between aggregate demand for and supply of goods and services was reasonably well maintained in 1951 and 1952, even though consumer prices advanced during the period. This increase stemmed primarily from rising rent and transportation costs and largely reflected the culmination of inflationary pressures that had been built up before the establishment of price and wage controls in early 1951, and before the Accord.

Flexible administration of general credit controls, coupled with other important factors, helped promote stable growth in 1951 and 1952. Among the other factors were the various selective and direct controls, including regulation of consumer and real estate credit, the voluntary credit restraint program, and price ceilings and allocation of scarce commodities; increases in taxes which offset, in part, rising Government expenditures; and, by mid-1952, a retardation in the rate of growth of defense expenditures.

Following the Accord, and throughout most of 1951 and 1952, Federal Reserve actions were designed to minimize inflationary credit expansion while at the same time facilitating the readjustment of the Government securities market to termination of support. In addition, and in keeping with the terms of the Accord, the System afforded direct support to Treasury refunding operations. Although purchases of Governments during such periods were substantial, the System was able to offset most of the acquisitions by sales or redemptions of short-term Governments. Thus between mid-April and November 1951, purchases of \$300 million of long-term bonds and \$1.5 billion of short-term issues were almost wholly offset by liquidation of \$1.7 billion of short-term Governments. The same technique, which was possible only because the System was no longer pledged to maintain

stable prices for Government securities and could therefore operate flexibly in the market, was used in February, June, August, and September 1952. Reflecting the effects of the termination of the support program, sustained demands for funds in the market, and the generally restrictive monetary policies, interest rates rose irregularly through 1951 on Government securities, corporate issues, and other debt instruments. In 1952, bond yields tended to level out, but short-term Government rates continued to increase. By the end of the year, interest rates generally were at the highest levels since the 1930's.

Inflationary pressures began to mount in late 1952 and early 1953, as defense expenditures rose further while consumer and business demand expanded. With credit demands strong and the economy operating close to capacity levels, the System exercised restraint in order to prevent excessive use of bank credit and inflationary expansion of the money supply. Member bank borrowing from the Federal Reserve Banks rose, interest rates increased and, in January 1953, the Reserve Banks increased their discount rates by 1/4 point, to 2 percent, in confirmation of the rate structure that had developed and to increase the cost of borrowing to member banks.

With the development of strains in the money and capital markets in the late spring of 1953, System credit policy was reversed, as manifested by substantial purchases of Treasury bills in May and June and by a reduction in member bank reserve requirements in July. At the same time, business activity leveled out, and then declined, primarily as a result of sharp cutbacks in defense expenditures and an accompanying shift by businesses from accumulation to liquidation of inventories. Throughout the remainder of 1953 and during all of 1954, monetary policy was directed toward ease in order to cushion recessionary tendencies and to provide a

monetary and credit atmosphere conducive to recovery.

The recession was both mild and short-lived, partly because basic forces of demand remained strong, and partly because easy availability of credit at low interest rates provided the basis for rising construction activity and, in late 1954 and early 1955, for a resurgence of consumer spending for automobiles and other durable items. It is important to note that actions taken by the monetary authorities in 1954, including open market operations designed to make bank reserves freely available, contributed significantly to the liquidity of the economy generally and of the banking system in particular. Confronted with reduced demands for loans, banks used the additional reserves made available through Federal Reserve action to increase sharply their holdings of Government and other securities. Between May 1953 and November 1954, total investments of commercial banks rose more than \$14 billion, with Governments accounting for almost \$12 billion of the increase.

As the first signs of economic recovery emerged in late 1954, the System permitted bank reserve positions to firm slightly in response to rising credit demands. Reflecting the widening of the recovery movement, credit demands continued to rise in early 1955. The System permitted bank reserve positions to tighten further and, in April, the Reserve Banks raised their discount rates $1/4$ point to $1-3/4$ percent, increasing the cost of borrowing to member banks and bringing discount rates into better alignment with market rates. This rate increase was a straightforward indication to the business and financial community that monetary policy had been shifted toward restraint as contrasted with the policy of ease that had been followed in the second half of 1953 and in 1954. Meanwhile, there had been a rapid increase in the use of credit for purchasing and

carrying securities, and margin requirements were increased in January and again in April.

By the time of the discount rate increase in April 1955, most of the slack that had developed in the economy in 1953-54, as reflected in ready availability of labor and other economic resources, had been eliminated. Pressures on costs and prices intensified as aggregate spending continued to rise. The accompanying demands for credit, in the face of inadequate savings and the gradually increasing restrictiveness of monetary policy, forced interest rates higher. The Federal Reserve Banks increased their discount rates in six steps, reaching a uniform level of 3-1/2 percent in August 1957. Despite these policies, wholesale prices began to rise in the latter part of 1955 and consumer prices in early 1956. The rise in consumer prices continued almost without interruption through 1957.

Monetary policy was once again shifted toward ease in the final quarter of 1957. With the abatement of inflationary pressures and the accompanying decline in loan demand in the fall, bank reserve positions were allowed to ease slightly in the latter part of October and early November. Then, as additional economic and financial data confirmed that the peak of business activity had been passed and that recessionary forces were developing, the Reserve Banks reduced their discount rates by 1/2 point to a level of 3 percent. Financial markets responded dramatically to this clear signal that monetary policy had been altered in view of the changing business situation and, by the year end, pressures on bank reserves had been eased considerably and yields on Government and other debt obligations had declined markedly from earlier peaks. Easing actions were continued in early 1958, as business continued to decline, and were reflected in significant easing in reserve positions of member banks and reductions in margin requirements,

discount rates, and member bank reserve requirements.

The preceding review indicates that monetary policy has been flexibly administered in the seven years since the Accord. A major question of interest, however, is whether the price inflation that occurred in 1956 and 1957 could have been wholly or partly avoided had Federal economic policy, including monetary policy, been designed to be still more restrictive. It is reasonable to assume that fiscal policies resulting in larger cash surpluses in fiscal years 1956 and 1957 would have helped restrain inflationary pressures. These surpluses could have been used in such manner as to limit the spending power of the private sector of the economy. In addition, the Treasury's financing problems would have been reduced, thereby facilitating the administration of a restrictive monetary policy.

In retrospect, there is little doubt that the direction of monetary policy was generally correct through the seven-year period. There is some question, however, whether the policy of ease was carried too far in 1954, when a combination of open market operations and reductions in discount rates and reserve requirements pushed available reserves of member banks to high levels and short-term interest rates to exceedingly low levels. As noted earlier, commercial banks utilized a large portion of the available reserves to purchase Government and other securities. While this action cushioned the 1954 recession and provided a basis for recovery by promoting growth in the money supply, it also contributed to the growth of liquidity in the banking system. Consequently, when policy was shifted toward restraint in 1955, and gradually became more restrictive through 1955 and 1956, commercial banks were in a position to meet demands of consumer and business borrowers by liquidating Governments and extending loan credit.

There also is some question whether the System moved fast enough in exercising restraint in the early and intermediate stages of the boom. Granted that a somewhat less easy policy in 1954 would have reduced commercial bank purchases of securities at that time, even the excessive liquidity existing at the beginning of 1955 might have been absorbed more quickly, and credit expansion thereby restrained further, had policy been tightened earlier and faster in 1955.

That the record bank loan expansion that occurred in 1955 and 1956 was an important factor in the inflationary push is indicated by continued expansion in business activity and rising prices, despite the restrained growth of the money supply during the period. The active money supply, consisting of adjusted demand deposits and currency outside banks, increased only 3 percent in 1955 and about 1 percent in 1956. The rate of use of the existing money supply, however, increased markedly during the period. The increase in velocity was facilitated by the liquidation of bank investments, particularly Government securities, the concurrent extension of private credit to business and consumer borrowers, and rising market rates of interest. This type of shift, within the framework of a stable or slowly expanding money supply, tended to be accompanied by an increase in money velocity as the recipients of the bank loans used the funds to spend for goods and services. During 1955 and 1956, a more restrictive credit policy might have curtailed the shift from bank investments to loans and restrained total spending.

These judgments, it should be strongly emphasized, are possible only on the basis of hindsight. It should be recalled that, in 1953-54, there was concern lest the recession deepen and lead to large-scale reductions in output and employment. At the time, there was little protest that monetary policy was being carried too far in the direction of ease.

It is even more important to recall developments in late 1954 and in 1955. The recovery from the recession of 1953-54 moved much faster than was generally expected; there were still doubts in early 1955 that the recovery was firmly established, and there was considerable apprehension that a move toward tighter credit at a faster pace might halt the recovery short of its full potential. Moreover, it should be recalled that at various times during the boom period, forces emerged that seemed to indicate a leveling off in business activity, or even an imminent decline. It is mainly in retrospect that the need for a more restrictive policy in the early stages of the boom seems clear.

PART II. ASPECTS OF INFLATION AND DEFLATION

Definitions

Few concepts in the field of economics have been subject to such a wide variety of interpretations as the terms inflation and deflation.

The variation in usage is revealed by noting some characteristics of four familiar definitions of inflation, all of which may be found, either explicitly or implicitly, in a wide range of economic writings:

1. Inflation is a general rise in prices produced by expansion of money and credit supplies at a more rapid rate than growth of the economy's output potential.

2. Inflation is a general rise in prices created by excessive Government spending and deficit financing.

3. Inflation is a general rise in prices elicited by an expansion of aggregate demands beyond the capabilities of the economy to supply goods and services at existing price levels.

4. Inflation is a general rise in prices fostered by wage increases in excess of productivity gains.

Each of the above definitions has the property of defining inflation in terms of an alleged cause of rising price levels. The first three find the core of the difficulty in factors affecting total spending, although the precise factors are not necessarily identical, while the fourth points to forces affecting production costs. Each regards inflation as a kind of economic disorder or disturbance, while considering the price movement largely as symptomatic of an underlying problem.

None of the above definitions may be regarded as "correct" or "incorrect." The question may be raised, however, whether a definition couched in terms of a specific cause of rising prices ever is likely to command universal support. It is preferable perhaps to choose a definition of inflation which is entirely neutral as to the source of advancing prices, a solution to which professional usage has turned increasingly. Inflation, in this view, is regarded simply as an upward movement of the general price

level, irrespective of the originating forces. As a corollary, inflation may be identified as a reduction in the purchasing power of money, which varies inversely with prices.

This definition leaves unanswered the important questions of causal factors and appropriate remedial actions but, by virtue of that fact, the air is cleared for meaningful discussion on these critical matters. Customarily, inflation develops during the expansionary phase of cyclical movements about the growth trend of the economy. On the other hand, an expansion in business activity may create enlarged employment and production without being classified as inflationary.

In similar fashion, a comparably neutral definition of deflation is one which refers to a situation where there is a generally falling trend of prices, i.e., an appreciation in the purchasing power of the monetary unit.

Thus, this view of deflation recognizes that periods of moderate contraction in economic activity need not always be accompanied by deflation, or a general reduction of prices. It is true that contractionary tendencies in the economy, in the past, nearly always have elicited a downward price readjustment. Nevertheless, it is evident from the behavior of prices during the mild recession of 1953-54--when selective price adjustments had comparatively little impact on the general price level--and again in the current recessionary period of 1957-58, that moderate contractions in business activity may produce little or no direct response in prices.

It is well to recall that inflationary or deflationary tendencies may operate for many months before accumulating sufficient strength to generate "open" inflation or deflation. And with respect to upward pressures on the price level, it may be noted that inflationary forces, having gathered strength, may be partially repressed over extended periods

by conventional industry pricing practices or governmental regulations and controls. In many industries, price adjustments are made at discrete intervals, and a considerable amount of time may elapse before the pressure of rising costs or the pull of rising demands is reflected in pricing decisions. The celebrated "inflationary gap" of the World War II and immediate postwar years exemplifies the repression of inflationary forces with Government controls.

Factors Affecting the Price Level

The relative importance of various sources of change in general prices has been a subject of continuing dispute over many years of economic observation and analysis. Manifestly, since the issue cannot be readily resolved, it is the purpose of this discussion to cite some major elements affecting price levels, to outline broadly the interrelationships among these elements, and to indicate the combined influence of these forces in producing inflation.

It is a matter of general economic intelligence that periods of rapid inflation have been characterized by especially heavy demands for goods and services. Postwar experience evidences three distinct periods in which the inflation problem has been thrust to the forefront of the economic scene--from about mid-1946 to mid-1948, the year beginning in June 1950, and the period from mid-1955 onward. In the first two of these three episodes are seen the inevitable aftermath of global war and the reflection of abnormal strains accompanying defense production and mobilization, while the third represents the effects of an extraordinarily vigorous capital goods boom, following a residential construction and consumer durable goods boom.

That war periods produce serious inflationary tensions no one seems to question, or to regard as unusual. It appears to be understood less readily, on the other hand, that peacetime booms give birth to a

multiplicity of price-boosting forces. The statement that supplies of goods and services are relatively inflexible in an economy running close to full-capacity production, so that further increases in demand encourage advancing prices, is but a partial expression of the potent inflationary forces inherent in a major industrial boom.

The encouragement of industries to ration short supplies of goods through price increases during boom periods is accompanied by a forceful push from advancing costs. These stem not only from the increased bargaining strength of organized labor as industry profits expand, but from the declining resistance of firms to wage demands as it becomes easier to shift cost increases to customers. Competitive bidding for scarce labor resources is another essential ingredient in the growth of money wage rates, and in the encouragement of wives, teenagers, and older workers to offer their services in the labor market. Significantly, these cost pressures are at their maximum when productivity gains are least likely to offer an offsetting influence. During recovery from a condition of underemployed resources, the initial phase of the upswing normally is accompanied by exceptional increases in efficiency, but these gains do not continue with further growth of output in relation to capacity. A well-established feature of cyclical experience is that productivity increases much less rapidly as the economy moves into the region of full-capacity production. Utilization of stand-by capacity, lack of experience with newly installed equipment, fewer shutdowns for routine maintenance, and the employment of less skilled and less productive workers are probably among the factors hampering the growth of efficiency in the late stages of industrial expansion.

It is because these cost pressures at the peak of a boom are intimately connected with the strains placed upon the nation's basic resources that traditional analysis of inflationary pressures has focused

upon the growth of aggregate demand in relation to aggregate supply. It should be noted, in this regard, that the expansion of demand need not have its origin in rapidly growing money stocks or in Government spending and deficit financing. The major sources of growth in spending during the recent boom scarcely can be attributed to such factors. For example, total spending on final output of goods and services advanced 20 percent between 1954 and 1957, while the money supply (demand deposits adjusted plus currency outside banks) rose a little more than 5 percent between these years. Moreover, the growth of total output in physical terms between 1954 and 1957, somewhat more than 11 percent, clearly outdistanced the expansion of money stocks. Federal purchases of goods and services, meanwhile, declined from 13.5 percent of Gross National Product in 1954 to 11.6 percent in 1957. Cash payments to the public by the Federal Government rose \$13.6 billion between calendar 1954 and calendar 1957. Although the growth of cash receipts from the public was more than \$2 billion larger than the rise in payments, the sharp increase in payments from an already high level may have had a mildly expansive effect on total spending. Such an effect would have been at a minimum in calendar 1956, when a \$5.5 billion surplus occurred in the Federal cash budget.

To recognize the importance of demand in "pulling up" prices, and to cite the close relationship between cost pressures and the current state of demand, is not to deny that cost increases--or attempts by producers to widen profit margins--may have an independent "pushing" influence on prices. Although firms necessarily must consider demand in establishing prices, it is evident that there are few areas in the economy in which prices are completely beyond the influence of the individual seller. Thus, a firm faced with rising costs or desiring to expand profit margins per unit of sales may, even in the face of constant demand for its output, elect to increase prices even though that may involve a decline in sales.

In this connection, a few remarks are appropriate concerning the alleged noninflationary character of wage increases which do not exceed productivity gains. It can be conceded that if wage increases in every firm were at the same rate as productivity gains in that firm, there should be no upward force on prices arising from this source. But widespread application of this rule is difficult to imagine when there are marked differences in productivity gains among firms in a given industry and among the various industries. Wage concessions granted to labor in those firms where productivity gains are largest tend to spread quickly to other firms in the industry, and to other industries, a process facilitated by the keen competition among individual labor organizations and by competition among employers. Also, the rule may be difficult to maintain when the structure of demand tends to shift to those industries where productivity gains are comparatively low. Transfers of resources from one industry to another are not costless, and attraction of adequate labor supplies to those industries where demand is rising may necessitate a rise in wage rates beyond that permitted by efficiency increases. In this case, price stability is threatened unless downward price adjustments in industries experiencing slackening demands match upward price movements in industries which are expanding output. The price structure, however, does not appear to be sufficiently flexible to ensure that these offsetting variations always will occur.

Mention of price inflexibilities suggests another line of reasoning whose implications have an important bearing on long-run price trends. For a variety of reasons, downward flexibility of many prices is comparatively small. The resistance of wage earners to wage cuts is only part of the story. Heavy contractual payments clearly undermine the willingness to reduce prices, as do Governmental controls--excise taxes, tariffs, minimum wage laws, and regulated prices, for example. Indeed, Governmental

policies are sometimes designed deliberately to prevent downward adjustments in specific prices. The support of agricultural prices, the elevation of tariff barriers to protect injured industries and retail price maintenance codes are specific examples.

The extent of these downward price rigidities militates against price declines in periods of moderate business contractions. Since inflation in periods of booming economic activity tends to become "built-in," price behavior in periods of cyclical expansion and contraction tends to be asymmetrical. Obviously, it might be possible to break down many of these price rigidities by permitting massive contractions of demands for goods and services, and corollary movements of production and employment, but such a solution is unacceptable in terms of the Employment Act of 1946.

Cyclical Fluctuations and Growth--The General Postwar Experience

During the postwar decade, the total real output of the economy has increased by an average rate of about 3.3 percent a year. Mild fluctuations in the growth rate have occurred, with annual changes ranging from an increase of nearly 10 percent to declines of slightly more than 1 percent. Total industrial production, covering the output of the nation's factories and mines, has grown more rapidly, averaging 4.5 percent a year. Annual changes in this broad sector of the economy also have been somewhat more pronounced, ranging from a gain of more than 15 percent to declines of nearly 7 percent. In agriculture, the rate of increase has been about 1.5 percent a year. On the whole, these figures indicate more rapid growth in real output during the years since World War II than during the last half century.

Growth in employment over the period has paralleled the expansion in real output. The rate of increase, however, has been much less and has averaged somewhat more than 1 percent a year. With the number of hours worked continuing downward, the rate of increase in man-hours

has been even less. For the private sector of the economy, the average annual gain in man-hour employment has been about 1 percent over the period since 1947. In agriculture, both employment and hours of work have declined. The differential rates of growth between real output and man-hours worked point up the enhanced productivity during the period.

During the postwar contractions, as has been true historically, aggregate unemployment increased more than employment declined. This reflects the tendency of the labor force to grow with the increased numbers of persons of working age in the population. Cyclical fluctuations in economic activity and job opportunities, however, do cause the rate of gain to vary over short-run periods.

In dollar terms, the gain in output during the postwar period is more pronounced than the increase in physical production. The corresponding flow of income likewise has risen more rapidly. For example, national income (total net income earned in production of goods and services) rose by more than 6.5 percent a year on the average. The differential between the two measures--money and real value--reflects the rising prices of goods, services, and the factors of production.

Prices of the goods and services in the Consumer Price Index have risen about 44 percent since 1946. Meanwhile, annual average prices of wholesale commodities increased nearly 50 percent. Average hourly and weekly earnings of manufacturing production workers, which provide a rough indication of the advance in price of an important kind of labor, have almost doubled over the period.

During the period since the end of World War II, there have been three distinct inflationary movements. In the first, prices reached a peak in the late summer of 1948. Wholesale prices during the interval from the beginning of 1946 to their high point in August 1948 shot up 53 percent and consumer prices rose by more than one third. Prices declined during

the recession of 1949, reaching a low point at the beginning of 1950. Wholesale prices declined 8 percent and consumer prices 4 percent during the interval.

A revival in wholesale prices had already started by the time the Korean War broke out in June 1950 but the rise was more rapid thereafter. In the early months of 1951, prices in wholesale markets were 19 percent higher than at the beginning of 1950. During the remainder of 1951 and 1952, wholesale prices declined slightly and subsequently remained stable in 1953, 1954, and the first half of 1955.

During this period--1951 through 1954--wholesale price movements did not parallel general economic activity, which continued to expand until mid-1953. This divergence between the movements of wholesale prices and over-all economic performance after early 1951 probably reflected in part a reaction from speculative buying and hoarding in both U. S. and world commodity markets that followed the outbreak of the Korean War. When supplies of raw materials and other commodities proved to be more than sufficient to meet demands, prices receded. Later, wholesale prices failed to move with general activity in 1953 and 1954, when they held steady in the face of reduced production, employment, and income.

The index of consumer prices also increased rapidly during the early phase of the second postwar inflationary period initiated in 1950. The swift pace of the advance was slowed somewhat during 1951, and after mid-1952 the index leveled off. At its peak, the Consumer Price Index was 15 percent higher than it had been in February 1950. During the subsequent decline of business, consumer prices held steady with only a minor tendency to decline.

The third postwar wave of price inflation began in mid-1955, when wholesale prices began to advance rapidly. Following its customary time lag, the index of consumer prices started to rise in the spring of 1956.

By January of this year, the increase amounted to about 7.5 percent in the wholesale index and about 6.5 percent in consumer prices, with recent advances generally being rather small.

This description of price movements throughout the past 12 years underscores the view that inflation has been a major postwar problem. The evidence shows both that periods of rising prices have been longer, and that the effects of these advances have been additive in that deflation has failed to reduce prices to the levels preceding inflation. Furthermore, the rate of inflation has been very uneven as prices proceeded on their upward course at an irregular pace.

Crosscurrents in 1957

Total real output during the first three quarters of 1957 was generally stable at the advanced levels attained in late 1956. During the last months of 1957, however, economic growth ceased and business activity began to decline. In an immediate sense, the decline may be related to changes in the volume of demand for goods and services. The rate of inventory accumulation had been reduced early in the year and in the fourth quarter liquidation occurred. The rising level of national security outlays ended in the second quarter and exports fell. Business outlays for new plant and equipment also began to decline in the final quarter of 1957.

Gradually changing supply conditions also were important. Adjustments made in basic resource supplies had significant impacts upon the demand for new business expansion and upon productivity and prices. By early 1957, pressure on the nation's industrial capacity was eased. Record volumes of spending for new plant and equipment had enlarged industrial facilities significantly. While the output capacity of major industrial materials was increased by an additional 9 percent or more during 1956 and 1957, production rates failed to exceed the levels attained early in 1956. Accordingly, the margins of unused capacity widened during 1957.

Capital expansion programs during the last boom undoubtedly were founded in part upon such considerations as anticipated demands in the 1960s and upon the presumption of continued rise in producers' goods prices, as well as upon current demand. Nevertheless, the lack of continued growth in current production posed a serious deterrent to sustained high levels of capital investment. The adjustment in the capital-output relation in major industries was thus an important factor in the slackening of business investment demand.

In the labor market, conditions changed gradually. As indicated earlier, the tightest period appears to have been during the latter half of 1956. During the first three quarters of 1957, total employment was generally above the level of the previous year, but the margin of gain diminished as 1957 progressed. Labor force participation rates--proportions of the adult population in the labor force--steadily fell below those in 1956. The length of the workweek also declined. These developments indicated that human resources were under considerably less pressure than they had been earlier.

The slowdown in production during 1957 was associated in part with the lack of significant growth in real consumption. Personal consumption in real terms recorded one of the smallest increases of the postwar period. Constant dollar expenditures for durable goods did not grow, while increases in nondurable goods and service consumption were small. The moderate increase in consumer demand apparently was in keeping with the very slight gain in real disposable personal income during the year. After tax deductions and adjustment for rising prices, the relative rise in personal income was the smallest in the postwar period. In addition, the increase in consumer credit outstanding was among the smallest during the last 12 years.

With the pressures on the nation's resources reduced in 1957,

productivity gains were again more favorable. The indicated gain for 1957 was still small, although appreciably larger than the gain in the previous year. In comparison with the increases in wage rates, the small magnitude of productivity gain caused a continuation of the upward pressure on unit costs and on prices during the year, although in reduced magnitude.

Wholesale prices rose much less in 1957 than in 1956. The rise in industrial prices in particular was quite small. The average for the year rose only 1 percent and the increase after February was very slight. Prices of producers' finished goods continued to rise but at a slower pace than during the previous year and a half. Similarly, wholesale prices of consumer finished goods increased only slightly, except for new model auto prices. Semifabricated materials and components rose moderately and crude material prices dropped significantly. Farm product and processed food prices continued to increase but at a lesser rate than in 1956.

In general, wholesale prices are more responsive than retail prices to changes in aggregate demand and supply conditions. The modest gains in such prices last year, particularly in industrial prices, is directly associated with the slackened rate of growth in demand and the generally easier situation in resource supplies.

In the consumer market, on the other hand, several circumstances--unrelated to current production--loomed strongly in the upward trend of prices during 1957. For example, the decline in meat supplies, due primarily to drought and its aftermath in widespread areas of the country, played an important role in advancing food costs during the last 2 years. More recently, freezing weather reduced the output of other food items which have resulted in price advances. Many service prices are subject to the approval of public commissions and therefore tend to adjust slowly to changed economic conditions. Much of the increase in rents, after release from control, reflects delayed adjustments to market conditions.

The significance of such special conditions in the consumer market may be realized by noting that service and food prices were primarily responsible for the rise in the Consumer Price Index last year. In no small measure, special circumstances such as those described above-- together with the time lag in consumer prices--explain the overlapping of inflation and slackening demands during 1957.

Part III. OBJECTIVES OF ECONOMIC POLICY

The question calls for our judgment of the relative importance of objectives of economic policy. The reply below begins with a brief summary of our position and follows with a more detailed consideration of Question 6. (See appendix.)

Summary

1. The three objectives should be considered as of broadly equal importance. (Price stability, employment stability, sustained economic growth.)

2. None of the three should be interpreted in terms of a target of 100 percent fulfillment--all can be taken in a relative sense.

3. By its very nature, objective number 3 (growth) does not require a stipulated quota of performance each year.

4. Such general objectives in relative terms can be posited, even in the absence of specific arithmetic criteria (i.e., allowable percentage of unemployment or tolerable creep of prices).

5. From a theoretical standpoint, we believe that the three objectives are generally compatible. Furthermore, we see no empirical evidence in the historical record which compels the conclusion that the three objectives must be considered mutually incompatible, although the practical difficulties of reconciliation are painfully obvious. There has as yet been little experience in a full-scale testing of monetary-fiscal policies, applied in a sustained and determined manner, to achieve price stability without sacrifice of the other two objectives.

6. As a practical or political matter, price stability is often relegated to a junior order of precedence. We believe that its relative rank could be elevated to a position of approximate equality with the other objectives.

Interrelation of Objectives

Price stability, business stability, and economic growth are closely interrelated.

In principle, stable prices, business stability at high levels of employment, and economic growth are mutually consistent. In practice, inconsistencies may at times develop. Excessive expansion or contraction in major sectors of the economy tends to be accompanied by inflationary

or deflationary tendencies; too much emphasis on one objective may impair ability to achieve the others.

Rising prices usually lead to waste, inefficiency, misdirected use of resources, and eventually to a boom which ends in depression. On the other hand, falling prices (when caused by shrinking demand) tend to be accompanied by declining production, idle plants, and unemployed labor. Price stability, therefore, appears to be essential, although not necessarily sufficient, for achieving business stability and steady economic growth.

High level employment is also consistent with achieving sustained long-term growth. Unemployment and idle facilities represent a waste of economic resources. On the other hand, attempts to maintain employment at a maximum level without regard to price stability may inhibit economic growth. In a dynamic economy, resources are continually being shifted from declining to expanding industries; improved machinery and techniques replace the old and obsolete. Such changes are essential for increasing efficiency and promoting economic growth, but they may also result in temporary unemployment. Efforts to prop up declining industries or to delay the introduction of improved techniques as a means of preventing unemployment prolong relatively inefficient methods of production and retard the rate of economic growth. Attempts directed primarily toward maintaining employment at a maximum level also create an economic climate which is not conducive to the most efficient use of productive resources. When demand is pressing against capacity, the emphasis is on getting more output. Costs and prices are a secondary consideration.

Inflation, formerly considered predominantly a wartime problem in this country, has become a threat in peacetime. Several developments have contributed toward this wider danger. Governments have assumed

responsibility for maintaining "maximum" employment. Collective bargaining has become a powerful force in determining wage rates. Several important industries are dominated by a few large companies, and the prices of their products do not respond readily to the free play of supply and demand. Fear of "creeping" inflation has led to protective devices such as escalator clauses which by their nature tend to perpetuate it.

It is extremely difficult, if not impossible, to keep aggregate demand strong enough to maintain full employment without spilling over into rising prices, especially with the close interrelationship between wages and prices under the present institutional structure. An increase in prices generates intense pressure for higher wage rates. Under conditions of full employment a wage increase can more easily be passed along in the form of higher prices. Thus an increase in either prices or wage rates tends to initiate a rising price-wage or wage-price spiral.

Fear of inflation has led to devices to protect real income from the erosion of rising prices. Some wage contracts tie wage rates to the index of consumer prices. Once prices begin to rise, regardless of the initial cause, wage rates increase automatically. If wage increases were limited to cost-of-living adjustments of modest proportions, so that they could readily be absorbed by increased efficiency of production, no further impetus to the price increases should result. And, as further efficiencies were achieved, costs would be lowered, so that real wages could be increased through price reductions. But when cost-of-living wage increases are added to basic wage increases that fully match or exceed increases in productivity, the tendency is to set in motion an upward spiral of costs and prices. In fact, as the experience of a number of countries has demonstrated, escalator provisions in wage arrangements can perpetuate a wage-price spiral of ever-increasing intensity,

with the result that the currency approaches worthlessness at an accelerating rate.

Although the wage "escalator" clause is best known, other devices have a similar effect. Some countries have issued "purchasing power" bonds, whereby the amount of interest and sometimes the principal are tied to the price index. Cost-plus contracts also tie contractual income to prices. With no incentive to cut costs, rising prices are likely to be fully reflected in higher costs and in a larger fee as well. Escalator clauses and similar devices, because of the accelerating effect once prices begin to rise, make it more difficult to achieve price stability.

The fact that the present economic environment facilitates operation of the wage-price spiral does not mean that inflation is inevitable. Wage increases are inherently inflationary when in excess of the rise in productivity for the economy as a whole; it is problematical whether, under all circumstances, action to limit credit and the money supply and thus to make more difficult the financing of business at the higher price level can prevent a wage-price spiral from continuing to push prices upward. However, credit restraint, properly timed, can be of great value in minimizing and possibly preventing or halting an upward spiral. The longer a spiral is permitted to continue, the more difficult it becomes to halt it without precipitating a decline in production and employment.

Policies directed toward maintaining maximum employment may result in long-run inflation even though a continual rise in prices is avoided. Recurrent booms may push prices upward. On the other hand, because of prompt actions to stimulate production and restore full employment, periods of recession may be accompanied by a halt to the rise of prices but little, if any, decline. With prices moving upward from a higher base following each recession the long-run trend would be a ratcheting

upward movement in the price level. Too much emphasis on full employment may prevent the effective restraint necessary to maintain price stability.

Success in promoting stability of prices and in avoiding wide fluctuations in production, employment, and income, however, will in general provide an economic atmosphere conducive to maximum economic growth--the third objective of economic policy. In a market economy, the forces that promote economic progress on the part of the individual are in general the same forces that foster a rising standard of living for society as a whole. While this view does not deny that government policies may accelerate economic growth, it does recognize that the major impetus for growth stems primarily from the efforts of individuals to promote their own well-being, within the framework of a stable economy, rather than concerted efforts of the government to elevate growth to a major objective of public policy.

Aside from the promotion of stability in prices and business activity, the contribution of public policy to economic growth lies mainly in fostering competition in the economy. Competition is a strong stimulant to growth. It sharpens interest in reducing costs, in searching out more efficient methods of production, and in discovering and applying new techniques and products. It places a premium on entrepreneurship and skills. It promotes business investment, both as a means of reducing production costs by introducing more efficient equipment and as a means of increasing capacity to capture a larger share of the market. Competition is, in short, the major stimulant to economical use of resources, both human and material, through technological progress and the elimination of waste and inefficiency in productive processes.

Given the pace of technological advance, the rate of economic growth tends to vary directly with the proportion of economic resources devoted to capital formation. While monetary and fiscal policies inevitably

affect the pace of capital formation, the precise allocation of resources in a market economy between production for consumption and production for investment is determined largely by the free choice of consumers and businesses. Experience indicates that the maintenance of reasonable stability in the value of money and prosperous economic conditions provides an atmosphere conducive to a sustained and satisfactory rate of economic growth. If this view is correct, stability of prices and business activity must be accepted as the primary goal of policy, with economic growth as a natural and desirable consequence of their successful attainment.

Moreover, it is important to recognize that, under conditions of relatively full use of economic resources, a faster rate of growth can be achieved only at the expense of current consumption. Such a choice should generally, in our opinion, be a reflection of individual preferences rather than a government decision.

These longer-run problems of harmonizing economic policy objectives have their counterpart in the short run. The current situation affords an illustration. The index of consumer prices has continued to rise even though production, employment, and income has been declining for a number of months, and recently the index of wholesale prices also has been rising. Sole emphasis on price stability would call for continued restraint to check the rise. A restrictive policy, however, would tend to intensify the decline in production and the rise in unemployment. Thus, policies directed solely toward price stability would be somewhat inconsistent with maintaining business stability and a full utilization of labor and productive facilities.

When such conflicts occur, monetary and fiscal authorities should reappraise the relative significance of the various objectives and select that combination which is most appropriate under the circumstances.

Relative Importance of Objectives

The relative importance of economic objectives varies with economic conditions. No specific ranking is appropriate under all circumstances. The particular combination that should be pursued at a given time depends on existing conditions and a careful appraisal of the probable consequences of the policies that would be necessary to achieve each objective.

Wide acceptance of the view that chronic inflation will be present in peacetime does not appear to be based on the conclusion that it is desirable per se or that economic instruments for preventing it are inadequate. Rather it seems to rest primarily on the premise that maximum employment is the goal of paramount importance, even though it involves the threat of long-run inflation. This premise tends to block the use of monetary and fiscal policies with whatever vigor is required to check rising prices and to prevent a decline in the purchasing power of the dollar. Such an emphasis on the employment goal, however, is subject to change, in the event of an increased realization of the economic and social damage which is wrought by inflation.

In any event, the pursuit of policies to achieve either of these objectives (full employment and stable prices) will inflict sacrifices and hardships on someone. Emphasis on the employment objective even though it results in recurrent inflation, may temporarily minimize unemployment but there is a price for someone to pay. Creeping inflation is like a termite. Working underneath a surface of prosperity, it constantly nibbles away the buying power of the dollar, favors speculative rather than constructive investment and so undermines the foundations of growth, and eventually may lead to runaway inflation.

A price increase of 3 percent annually, although small in itself, would in 20 years reduce the buying power of the dollar by nearly one-half. One effect would be to wipe out a substantial part of the real

value of money savings and fixed incomes. It would inflict heavy losses on millions of people with savings deposits in banks, shares in savings and loan associations, and life insurance; and impose a sharp reduction in the standard of living of those with fixed incomes, such as recipients of annuities, pension, and other forms of retirement income. The hardship is just as real, although not so obvious, as the loss of income resulting from unemployment; and to a large extent the burden falls on those least able to bear it. Secondly, as it became clear that money savings were faced with progressive shrinkage in purchasing power, the flow of savings into savings institutions would tend to decline, there would be a shift from money and fixed-income obligations to equities and real property, speculation and waste would be encouraged, and maladjustments would be created among different types of economic activity. These developments would accelerate the pace of inflation and thus intensify the hardships imposed on much of the population. If carried far enough, it could eventually lead to chaotic conditions in the economy. But even in the absence of such a culminating phase, the consequences of substantial inflation are damaging enough to warrant very strong efforts to prevent it.

Likewise, an effective use of monetary and fiscal policies to help maintain price and business stability cannot be entirely painless. In essence, a restrictive monetary policy designed to prevent spendable funds from rising more rapidly than the output of goods and services available for people to buy, limits the total quantity of credit available to borrowers. Some would-be borrowers are deprived of credit which otherwise would be available. But the limited supply is allocated among borrowers by market forces instead of by the decisions of some regulatory agency.

It is well to note that using direct controls as a means of maintaining maximum employment without inflation also has its price.

Experience demonstrates that a harness of direct controls over prices and wages creates rigidities and distortions, makes adjustment to change slow and more difficult, infringes upon individual freedom, and stifles private initiative. The long-run effect is to inhibit not only the mobility of resources, but growth itself. In addition, direct controls are inconsistent with the principles laid down in the Employment Act that maximum employment, production and purchasing power should be promoted in ways that would foster and promote free competitive enterprise.

Even more important, perhaps, is the fundamental weakness inherent in direct controls. The fact that they are needed is conclusive evidence that aggregate demand is in excess of the amount which is consistent with price stability. Their purpose is to suppress the effect of excessive purchasing power on prices. With prices controlled and supplies limited, however, money accumulates which cannot be spent for the goods people want to buy. Experience suggests that before long, workers may decide that greater satisfaction can be derived from more leisure rather than more work. Inability to convert income into goods dulls the incentive to work, spawns inefficiency, and leads to conditions inimical to economic growth. Furthermore, if long continued, the accumulation of pent-up purchasing power is almost certain to lead to violations, the growth of black markets, and eventual price inflation.

Selecting the most appropriate goals of economic policy is a difficult and complicated task. General economic welfare can best be promoted, it seems, by carefully weighing the advantages, and the sacrifices and hardships involved in pursuing policies designed to achieve alternative objectives. The long-run as well as the short-run effects should also be considered. Only in this way can men of judgment reach a sound decision as to the particular combination which seems most appropriate for a particular situation.

PART IV. FISCAL AND DEBT MANAGEMENT POLICY

The comments that follow are submitted in an effort to be responsive to the Committee's questions concerning fiscal and debt management policies, even though such policies are not within the area of responsibility of the Federal Reserve System. The discussion is intended to be theoretical and analytical, rather than to recommend any specific policies or courses of action.

Fiscal policy

In principle, the view is widely held that fiscal policy should be conducted in an anticyclical manner, with Government revenues exceeding expenditures in boom periods, and expenditures exceeding revenues in periods of recession, so as to help compensate for major swings in private spending. To some extent this now tends to occur automatically under the present fiscal structure, as most of the major types of taxes tend to produce greater revenues in periods of expanding activity, income, and private spending, and considerably smaller revenues in periods of declining activity. Furthermore, under continuing programs some types of expenditures tend to contract in prosperous times and to increase in periods of recession. For example, disbursements from unemployment trust funds, grants-in-aid to the states for public assistance, and to some extent old-age benefits decline in periods of expanding business activity, and increase in periods of recession and rising unemployment.

To be most effective as an anticyclical influence, however, the automatic variability of receipts and expenditures in response to changes in economic conditions may need to be re-enforced by active efforts to restrain Government expenditures when private (business and consumer) spending is high and to accelerate governmental projects when private spending is declining. Similarly, to the extent that tax reduction is

possible within the framework of a budget balanced (on a cash basis) over the full cycle, the reductions would be most conducive to economic stability if effected when recessionary tendencies prevail. And if increased taxation is required to achieve over-all budgetary balance, the tax increases would best be effected in periods when expansive and inflationary tendencies prevail.

Furthermore, different types of expenditures and receipts have different economic effects. Government expenditures that require large amounts of materials and labor, such as public works, public housing, and highway construction, and of course, direct or indirect subsidies, would be most useful in promoting steady growth of the economy if they could be concentrated in periods of recession.

In the field of taxation, similarly, some types of taxes are believed to bear more heavily on consumer spending, while others are believed to bear more heavily on saving and investment. For example, broadly based taxes such as excise taxes (especially retail sales taxes) and the "normal" income tax are considered to have greater impact on consumer spending than on saving, whereas the progressive surtaxes are considered to have greater effects on saving. The actual effects of such taxes on spending and saving, however, are not measurable. The economic effects of corporation taxes also are very difficult to measure. The corporation income tax is commonly considered nonregressive. There is generally a strong tendency, when tax reduction is considered desirable in order to exert a stimulating effect on the economy, to place primary emphasis on reductions in personal income and excise taxes. But it is questionable to what extent the corporation income tax is actually nonregressive. The fact that the average ratio of net income after taxes to invested capital in recent years has been much the same as in earlier periods of high activity, when tax rates were much lower, would

seem to suggest that corporations in general have been able in fixing selling prices to treat the tax on profits as an item of cost and so to pass the tax along to customers.*

The present fiscal system

The current levels of expenditures and receipts have made the fiscal policy of the Federal Government a far more important influence on the economy than in earlier days. Government receipts have taken between 20 and 25 percent of total national income in recent years, and Government purchases of goods and services have accounted for 11 to 15 percent of total gross national product, in addition to which large amounts have been returned to the public through transfer payments and interest on the public debt. Sizable variations in Government expenditures or in Government receipts, therefore, can have profound effects on the economy. In the recession of 1953-54, for example, the curtailment of Government expenditures following the end of the war in Korea accounted for a much larger part of the decline in gross national product than the net decline in private expenditures. On the other hand, the substantial tax reductions of 1954 undoubtedly helped to promote early recovery from the recession. And in 1949, the increase in Government defense and other expenditures, together with a reduction in tax collections, went far toward offsetting the decline in business inventory and other investment and stimulating consumer spending.

Over the postwar period as a whole, the budgetary position of the Government--in the sense of the over-all balance between total payments and total receipts--does not appear to have been a major

* It is sometimes argued that, to the extent that accelerated depreciation on plant and equipment has been permitted for tax purposes, corporation profits in recent years have been understated. On the other hand, it is argued with at least equal force that far more generally the practice of basing depreciation on historical cost, rather than reproduction cost, has resulted in serious overstatement of corporation profits.

inflationary influence. The delayed effects of the huge wartime deficits, together with the shortages of civilian goods that accumulated during the war, were probably the most important inflationary forces in the early postwar years, 1946-48. In fact, the large cash surpluses of the Treasury in calendar years 1947, 1948, and 1956 were helpful in restraining the inflationary tendencies of those years, and the smaller surpluses in 1951 and 1957 were at least on the right side of the line. On the other hand, the deficits of 1952 and 1953 contributed to the inflationary influence of real or anticipated shortages of goods (actually more anticipated than real) during the Korean war period.

But the net budgetary position, even on a cash basis, does not tell the whole story. The very magnitude of Government expenditures, and the levels of taxation required to meet them, have effects independent of the balance of receipts or payments. The current high levels of Government expenditures, and their tendency to follow a long-term upward trend, have made them a much more important element in the economy than in earlier years, and a fairly stable one. But even within a fairly steady total volume, shifts among the various types of expenditures can have substantial effects on particular industries or areas of the economy. For example, the shift of emphasis from military aircraft to guided missiles during the past six months or so has had a depressing effect on aircraft production and employment, with the eventual effects in terms of manpower and material requirements still uncertain.

Furthermore, even with a balanced budget, Government expenditures and taxes at current high levels can exert inflationary influences. For example, the corporation tax rate is so high that the effect of higher interest rates in restraining borrowing in a boom period is diluted, since it is said that "the Government pays more than half the cost". Also, incentives to efficiency and avoidance of wasteful or

unnecessary expenses are greatly weakened, with inflationary effects. Quite aside from such tax aspects, it becomes extremely difficult to achieve economy and avoid inflationary influences in Government operations and procurement when the aggregate volume of expenditures is so huge.

Another major weakness of fiscal policy as an instrument of national economic policy is the difficulty in obtaining timely public support and Congressional action for the fiscal measures that would be most conducive to economic stability in the sense of steady, sustainable growth without inflation. It is usually difficult, except in periods of national emergency to get public support for increased taxation, especially of the kinds that would be most effective in restraining inflationary tendencies; and curtailment of Government spending finds more favor in the generality than in the specifics. On the other hand, when tax reduction or accelerated expenditure appears to be appropriate to exert a sustaining influence on production and employment, it is usually a time-consuming process to reach agreement on the types of tax reduction or of increased expenditure that will be most appropriate to the circumstances. And even if the initiation of changes is well timed, the expenditure programs adopted may attain their greatest momentum when they are no longer needed, and so give rise to new unstabilizing forces. Similarly, new taxes levied to meet the needs of a particular situation are frequently retained long after the particular circumstances that led to their adoption have passed; and tax reductions also are hard to reverse except in emergency situations.

One great difficulty is that of appraising the extent of the need for a specific fiscal policy and how long it will be needed. Despite all the improvements that have been made in economic data, forecasting remains a decidedly imperfect art. The current situation may be

used to illustrate the point. In so far as the current recession represents an inventory adjustment, it should provide its own remedy within a few months. Another and more important factor, especially from the viewpoint of duration, however, is the decline in business investment in plant and equipment, following the development of excess capacity in a number of industries. Planned expansion of national defense expenditures, together with the rising trend of state and local government capital projects and a possible acceleration of residential construction, should go far toward offsetting the decline in business investment, but the relative timing and momentum of the various factors are uncertain.

Meanwhile, major questions are how well consumer spending-- the largest single element in the national economy--will be sustained, and how far the curtailment of business investment will go. Recent data on consumer spending have been difficult to interpret because of the complicating influence of unusually severe winter weather in much of the country. Developments in this area, probably more than any other, will determine whether Government intervention, in the form of tax reduction or a large increase in public works, is needed to counteract the recessionary tendencies. If there is a normal seasonal pick-up in such things as automobile sales and residential building during the spring months, and consumer spending generally is well sustained, and if the contraction in business investment is not accelerated, quite moderate action on the part of the Federal Government might be sufficient. On the other hand, if it should appear that consumer spending is being substantially curtailed as a result of unemployment and apprehensiveness concerning future prospects--and perhaps also by the burden of existing consumer debts--vigorous steps in the form of prompt-acting governmental measures would be indicated.

In the tax field, probably a substantial but temporary reduction

in broadly based taxes would be most effective and appropriate (temporary, in view of the prospect of a rising trend of Government expenditures and probably sizable deficits ahead). This does not necessarily mean, however, that tax reductions should be limited to personal income and excise taxes. Some forms of corporation tax reduction might also be expected to have stimulating effects on business activity and employment. For example, some countries have used variable depreciation allowances to stimulate business spending on plant and equipment in periods of reduced activity and to restrain such expenditures in periods of high activity.* And, in the expenditure field, the preferable emphasis would be on projects that have been started and can readily be accelerated, or on projects that are past the planning stage and can be put into motion rapidly. The great danger in a public works program is that it will only attain substantial momentum after the greatest need has passed, and may then accentuate inflationary tendencies by competing with other active demands for materials and manpower--especially the latter unless care is taken to select projects that are clearly needed and are of such types and so located as to provide employment for the unemployed. At best, public works cannot be expected to make effective use of the particular skills of many of those who are out of work.

State and local government finance

Major parts of state and local government expenditures, such as expenditures for education, police and fire protection, maintenance of public institutions, street and highway maintenance, and other public services are not greatly influenced by economic conditions. But there

* In the present situation, with excess capacity in many industries, more liberal depreciation allowance on new investments in plant might not have much effect in inducing acceleration of expansion plans, but might accelerate replacement of inefficient or obsolete equipment with a view to achieving cost savings and relieving the squeeze on profits.

are other parts, such as the construction and improvement of public institutions and highways which ideally might be accelerated or retarded to help compensate for the wider swings in private spending, and thus exert a countercyclical influence on the economy. Practically, however, such countercyclical timing of construction projects appears to be very difficult to achieve, even though it might result in appreciable savings in costs. The principal types of state and local expenditures which tend to rise in periods of recession and to contract in periods of expansion are unemployment benefits and other forms of public assistance to the needy, much of the financing of which is done by the Federal Government. Major capital expenditures of state and local governments are usually financed by the sale of securities, rather than by current taxation, but frequently require the approval of the voters before the additional indebtedness can be assumed. And even though savings might be achieved by moving forward or postponing such projects to periods of recession, the tendency frequently is to delay them until the need is clearly urgent, and then to proceed regardless of economic conditions and costs. In fact, projects involving large expenditures are more likely to be voted down in periods of recession, since taxpayers are particularly reluctant to assume new burdens at such times, although projects previously approved are carried forward. On the other hand, shortages of materials and unfavorable conditions in the capital markets may retard such projects in boom periods. The net result has been a generally rising trend of state and local expenditures through prosperity and recession during the postwar period.

Since the fields of progressive taxation of personal income and taxation of corporation profits are so largely pre-empted by the Federal Government, state and local government revenues are derived largely from real property taxes, general and specific sales taxes, and

certain basic business taxes which frequently are independent of profits earned. Consequently, while they have shown a generally upward trend, they have varied only to a minor extent in response to changes in business conditions. As a result, they have tended to become more burdensome in periods of business recession, and less burdensome in periods of prosperity.

Debt management policy

For some years economists rather generally have urged that the management of the public debt be conducted in such a manner as to reinforce countercyclical fiscal and monetary policies. More specifically, the general policy advocated is that the Treasury place particular emphasis on the sale of long-term securities during periods of high activity and inflationary pressures, and on the sale of short-terms during periods of recession. A primary purpose would be to divert investment funds from private investment and thus restrain tendencies toward over-expansion in prosperous times, and to avoid competition for the available supply of investment funds in periods of reduced business activity and unemployment.

Furthermore, in a period of expansion the use of the proceeds of sales of long-term securities, together with the surplus revenues which an appropriate fiscal policy should provide, would be used to retire short-term debt held by the banks and others, thus reducing the liquidity of the banking system and helping to make restrictive monetary policies of the central banking system more effective. In a period of recession, the proceeds of Treasury sales of short-term securities (presumably largely to the commercial banks) would be used to meet Government deficits, and perhaps to retire long-term securities. A result could be to offset, or more than offset, the decline in bank loans characteristic of a period of recession, thus maintaining or increasing total bank credit and

the money supply, and at the same time increasing bank liquidity and re-enforcing an "easy" monetary policy.

The experience of recent years, however, has raised questions concerning the feasibility and, to some extent, the desirability of such a debt management policy. In the first place, the heavy demands for capital in a period of high activity tend to make the financial markets unreceptive to long-term Treasury securities and to require the Treasury to bid up interest rates progressively if it is to be successful in diverting funds from other uses. The Treasury is likely to be severely criticized by potential borrowers (such as builders and municipalities) who find it most difficult to compete, and by others in the role of taxpayers who object to the increased service charges on the public debt.

Furthermore, the increased liquidity of the banking system that results from large sales of short-term Treasury securities to the banks in a period of recession (such as 1953-54) delays and limits the effectiveness of restrictive monetary policies when inflationary tendencies again become a problem. These difficulties have led some observers to conclude that the Treasury should abandon any attempt to use debt management policy as an instrument of national economic policy, and should be guided by market conditions in deciding upon the type and maturity of securities to be offered at any given time. In the long run, presumably the Treasury would direct its efforts primarily toward achieving wide diversification in the maturity structure of the public debt, and avoiding excessive concentration in short maturities. This would reduce the amount and frequency of refunding operations required, and thus would reduce to a minimum the interference of debt operations with the execution of monetary policy. The Treasury would not try to force long-term issues on an unreceptive market, but would ordinarily limit its offerings to short or intermediate maturities under tight

money market conditions. That, of course, would mean that the Treasury would have to do most of its long-term financing in periods of easy money conditions, when funds for long-term investment tend to be more readily available and other demands on the capital markets tend to become less pressing.

A third alternative would be to follow an intermediate course. While avoiding attempts to float large amounts of long-term securities, and thus to withdraw funds from the private capital market in important amounts during periods of expansion, the Treasury might try to sell limited amounts from time to time at competitive rates. If this proved successful, there would be less need for large offerings of long-term securities, designed to maintain satisfactory maturity distribution of the public debt, in periods of reduced business activity and employment. But moderate amounts of long-term financing might be done even then, at least after the initial recession phase, to provide an outlet for savings in excess of other current demands in the capital markets. (The amounts, perhaps, would depend upon the general vulnerability of business conditions and the extent of other current demands in the capital market for available savings--although this would not preclude some modest competition for savings by the Treasury against other demands.) And to the extent that there was need for the financing of sizable budgetary deficits, securities designed for commercial bank subscription might well be issued in diversified maturities up to ten years. This would facilitate an appropriate distribution of bank portfolios, and help to avoid the development of excessive liquidity in the banking system which would be likely to result from heavy emphasis on short-term financing during a period of recession. While such a compromise debt management program would be of limited use as an instrument of anticyclical economic policy, it would at least involve a minimum of

interference with anticyclical fiscal and monetary policies, and should involve less difficulty than an attempt to carry out a thorough-going anticyclical policy--a policy which has not yet been found feasible for any extended period.

Part V. ADEQUACY OF THE MONETARY SYSTEM

There is probably no unanimity of opinion about the adequacy of any monetary system, but most observers would include in any judgment the following criteria: (1) stability of value; (2) responsiveness to economic change in accommodating orderly economic growth; (3) allocation of the credit created by the banks in such a way that the nation's resources are used effectively; and (4) adaptability of the money-creation process to accord with the objectives of public policy.

Stability of Value

The term stability of value is generally used to signify some constancy in purchasing power over goods. The limits of tolerance exclude both a rapid and continuous rise of the price level and a severe fall in the price level. At times this country has experienced some instability in the value of money in terms of price change, but thus far the severe losses of purchasing power have been confined to periods of adjustment to the financial and other consequences of war emergencies. The extreme upward surges of the price level like those of 1914-20 and 1946-51, and similarly the violent collapses such as that of 1929-33, in fact, approached highly undesirable extremities. Monetary developments played a role in those fluctuations, but they cannot be said to have been an originating cause.

Another connotation of stability of value is constancy of purchasing power in terms of gold and foreign currencies convertible into gold. In this sense, the dollar has been dependable and stable for many years except for a brief period in the early 'thirties. The United States today provides a fixed point of reference for national currencies, and this reference point is the dollar and the dollar price of gold. The dollar continues to be the most generally acceptable currency in the world

today. The integrity of the dollar depends in the final analysis on the productive power of the American economy in conjunction with successful handling of fiscal and monetary problems.

Responsiveness of the Monetary System to Economic Change

Congress endowed the Federal Reserve System with the power to provide a flexible supply of money and credit, recognizing that elasticity in the money supply can facilitate economic change and growth and that a rigid or arbitrarily limited volume can stifle development. The present financial institutional arrangements within the monetary system facilitate an allocation of resources among different regions, industries, and firms. The system permits funds, and the resources these funds represent, to be channeled to those areas or businesses which are able to use them most efficiently. The present monetary system provides fluidity of funds in a free market economy. Organized and interrelated as it is, it represents a cohesive whole which makes possible intensive utilization of available funds.

This flexibility has generally worked well and has assured satisfactory handling of the changing transactions-requirements of an economy whose population and labor force have increased 75 percent in the 44 years since the Federal Reserve was established. During those four decades, the sheer physical output of goods and services has expanded to a volume scarcely imaginable in 1914. Many undreamed-of products and services have entered into the composition of the gross national product, with accompanying basic shifts in regional distribution of productive capacity and population. Moreover, at various times in that half-century the economy passed through serious depressions and at recurring intervals became involved in problems of war finance. Each successive phase brought to light new needs, which have been recognized by Congress, not only in monetary and credit institutions and in the policy instruments available to the Federal Reserve System,

but also over a much broader range of public policy and responsibility.

The adaptability of the monetary system is more specifically illustrated over the period since World War II and, in particular, with the return to a flexible monetary policy beginning in 1951. During the years 1952-1957 as a whole, the economy experienced a substantial rise in economic activity. Despite the '53-'54 setback, the average rate of increase in physical production over the five-year period, '52-'57, was in excess of the long-term growth trend. Savings and new bank credit facilitated shifts in production and allowed basic productive capacity to be expanded at a rapid pace. Recurrent inflationary price developments, however, posed a serious problem.

The ideal role of bank credit is that of meeting the real needs of the economy without contributing to inflationary developments, as competing demands for raw materials and finished products tend to press against available supplies. By and large, bank credit has filled this role. The postwar decade brought a rapid rate of technological as well as organizational improvement reflected in a high output increment per unit of capital formation. Through this period of major change, with its inherent potential for temporary distortion of the economy and strain on many prices, monetary policy has operated to limit excessive demand in the money market and in the economy in general.

The less constructive aspects of financial history since 1951 are reflected in the price rises which have occurred in the period since the 1954 recession. The generally strong demands for both consumer and capital goods permitted price advances of sufficient size and persistence to raise questions as to the future value of the currency. The price advances have reflected primarily nonmonetary forces rather than excessive expansion

of the money supply, and raised questions as to the feasibility of restraining such forces by monetary policy alone.

Allocation of Credit

The varying forces of supply and demand in different sectors of the freely functioning money and capital markets allocate available credit and capital among the myriad seekers of funds through variations within the structure of interest rates, taken in the context of differences in risk, maturities, etc. The heart of the allocative process lies, of course, in arrangements that assure each borrower the possibility of access to competing sources of funds, and each investor the possibility of choosing among competing borrowers or types of investment.

The power to limit or influence the total volume of money, and the additions to the total supply of credit which are derived from changes in bank credit and the money supply, is the responsibility of the Federal Reserve System. The use of this credit by specific borrowers and sectors of the economy is influenced by the cost of the credit and the ability and willingness of the lenders to extend it. This willingness is influenced by the balance between reserves which are freely available and reserves that must be obtained through borrowing at the Reserve Banks at the discount rate. The Federal Reserve Banks are the principal suppliers of reserves, and they may add to or subtract from the reserve base as they create (or extinguish) their own credit through open market purchases (or sales) of securities or advances to member banks. Changes in the availability of reserves may also be effected through changes in the level of reserve requirements. An increase or decrease in the reserve base exerts pressure toward increased or reduced availability of credit and a larger or smaller money supply, with an accompanying tendency for rates to rise or fall and lending terms to ease or tighten. Changes in interest rates

are the means by which market forces effect a balance between supplies of funds and demands for funds at any given time. Since the banking system and the credit and capital markets of the nation are closely interconnected, interest rate changes quickly affect a wide range of credit instruments. Furthermore, uncertainty created by changes in rates affects the whole complex of lenders' and borrowers' decisions. And under conditions where the System has limited the availability of credit, lenders are inclined to ration the available supply among various users.

Federal Reserve monetary policies thus function through the commercial banking system, and regardless of the instrument of policy used to influence credit, the supply of bank reserves is affected. Although non-bank lenders and investors may be affected directly or indirectly by Federal Reserve operations, the most significant result is change in the money supply and corresponding change in the credit structure.

Role of financial intermediaries. One aspect of developments in the monetary system in recent years has been the significant growth of such financial intermediaries as mutual savings banks, savings and loan associations, and life insurance companies. The claims on such financial intermediaries (including savings deposits, savings and loan shares, policy reserves, and other financial assets) differ in essential fashion and function from demand deposits.

In contrast to other financial institutions, the commercial banking system can, if additional reserves are made available, expand its deposits by several times the added reserves as banks make new loans or purchase securities. Bank deposits are expanded as a result of the monetization of the debts of borrowers. In the case of the financial intermediaries, acquisition of debt instruments involves the exchange of one asset (demand deposits in a commercial bank) for another (the investment acquired). Total

assets cannot be increased by setting up demand liabilities in favor of the borrowers.

Thus, it can be said that commercial banks create the effective money supply in the form of demand deposits, which are an independent variable at the margin of the credit supply. The financial intermediaries cannot on their own initiative, either individually or as a system, enlarge the money supply of the public by expanding their liabilities. Most of the increases in the total of claims against the financial intermediaries depend upon an act of saving by individuals. The rise in savings, instead of representing an addition to spending power, generally reflects the diversion of a part of personal income from spending on consumer goods to the financing of productive facilities, homes, and other capital uses.

It is true that demand balances at the commercial banks may be activated as funds are recirculated by the intermediaries through their investment operation, and that the velocity of deposits may thus be increased. Many other types of transactions, however, are reflected in changes in the velocity of money. Velocity will undoubtedly continue to reflect the effect of changes in business activity and in interest rates, and will need to be continuously taken into account in assessment of the credit situation. But that is not a new development, and present institutional arrangements in the United States seem adequate to prevent serious interference with credit policy arising from changes in velocity.

Position of commercial banks. In evaluating the growth of non-bank financial intermediaries, consideration should be accorded the fact that commercial banks have maintained their position of relative importance in the economy during the past forty years. In 1916-17 the nation's commercial bank demand deposits were equivalent to about 24 percent of gross

national product; currently they amount to about 26 percent. Thus, for as long a period as there are reliable statistics, commercial banks have shown no decline in importance. The ratio of the money supply to gross national product declined during the postwar boom, but the decline followed a rapid wartime rise, and the ratio is not lower now than it was in the 1920s.

Adaptability of the Monetary System

Even as late as the decade prior to the establishment of the Federal Reserve System, predominant attention was directed to money in the form of circulating currency, when considering the monetary and credit relationships to economic activity. During the depression of the 1930s, the tendency was to turn to fiscal policy as the predominant instrument of economic policy. Through World War II and into the postwar period the operations of the national Government, and at times those of other instrumentalities, became highly important in their effects on economic developments. After the early postwar years, however, there was a widespread tendency here (and abroad) to turn again to monetary policy as an important instrument of economic policy. Thus, in the last decade, it has become customary to view monetary and credit policy, fiscal policy, and public debt management as essential complementary parts of any program working toward the objectives of economic policy--realization of the potential for growth, avoidance of serious instability of production, employment, and prices.

Monetary policy deals most directly with the sources of changes in the money supply. Fiscal and debt management policies cannot of themselves create or extinguish money. They can only take such action as may lead to changes in credit conditions and economic activity within the framework of contemporary monetary policy. Since changes in credit and

capital markets have a large influence on the general state of expectations of business and consumers, it is important that balance be maintained between the supply of reserves and bank credit, and the physical growth of the economy. Fiscal policy, which concerns Government expenditures and receipts, can have direct effects upon demands for goods and services and on spendable incomes.

Effective co-ordination of monetary policy, fiscal policy, and debt management depends upon sympathetic comprehension and treatment of mutual problems by the Federal Reserve and by the legislative and the executive branches of the Government. Fiscal policy as determined by Congress must be based on many considerations, but one important factor should be its impact on economic stability. The real problem is not a selection of either fiscal or monetary instruments of economic policy in preference to the other, but to co-ordinate them in such a way as to gain the particular advantages and mutually reinforcing action of each in pursuit of economic policy objectives.

Monetary policy has the advantage of being an impersonal, flexible, and adaptable instrument. Monetary measures can be taken with a minimum of delay; their immediate effects can be measured with some accuracy. Reasonable adjustments can be made quickly to changes currently visible. The instruments used in policy decisions make possible continuous contact with the banking system and the money market. Even though discounting is done at the initiative of individual member banks, open market operations are undertaken solely at the initiative of the Federal Reserve. The Federal Reserve, because of the interrelationship of these two instruments, is able to retain control of the reserve position of member banks and thus influence their credit policies. Fiscal policies and debt management policies, on the other hand, are less flexible and adaptable.

Fiscal policy, like monetary policy, suffers from imperfect visibility as to the economic conditions to be encountered. In addition, it entails a sizable lag between the considerations of measures to be taken, definite decisions, and their execution; and by its nature involves rigidities. These factors hamper satisfactory design of the revenue structure so that tax revenues at given rates increase or decrease in a higher proportion than fluctuating national income, thus tending to produce budget balance over the cycle of economic activity with alternating deficits and surplus. The automatic features, however, which have been incorporated in postwar Federal budgets exert a stabilizing influence, and their force may affect both upward and downward movements of business since revenues rise in a higher proportion than output when output rises, i.e., spendable private income rises less than output. This influence, however, may not be realized if surpluses occurring in periods of prosperity are used to finance additional or expanded programs rather than to retire debt. Avoidance of a continuously rising debt and resulting inflationary pressure calls for fiscal discipline of a high order.

So long as the budget is dominated by defense and related expenditures, and so long as obligations of earlier wars and transfer payments are relatively large, it will continue to be difficult to distribute Federal expenditures on the basis of positive goals and to vary the size of the Federal budget in relation to private spending.

In periods of underemployment, fiscal and debt management policies have certain advantages over some Federal Reserve actions. They may have a more direct effect on the demand for goods and services. Monetary policy, however, can be made effective more quickly and may be sufficient during a moderate recession. It counters declining business activity through lowering the cost of credit and increasing its availability as well as by

reducing pressures for forced liquidation of inventories or other goods. Given a strong underlying demand, growing population, expanding wants, and rapidly changing technology, an increased availability and lower cost of funds tend to induce increased expenditures by individuals, state and local units, and by business. Terms and conditions for the purchase of a wide range of goods are brought within reach of an increased number of credit users. Many types of business and municipal capital expenditures react to favorable prices and a ready availability of funds for financing. This situation is encouraged when the banking system is strong and liquid. On the other hand, when the overriding problem is one of inflation, monetary policy may play a more effective and central role than in a recession.

The large public debt in the postwar period has emphasized the need for a close understanding between those responsible for debt management and monetary policy. The Federal Reserve must take adequate account of fiscal and debt problems in effecting credit policy; the Treasury needs to take account of credit policy in managing the debt. At times, debt operations have tended to interfere with the execution of restrictive monetary policies as well as of fiscal policy. Largely, this has come about through the influence of the maturity structure of the debt--on interest rates and in altering the liquidity of the banking system and the economy at large. Debt management decisions as they affect the maturity structure of assets held by private investors, including the commercial banks and nonbank financial intermediaries, have a pervasive effect. The significance of liquidity is found partly in its effect on the willingness and ability of individuals and business to dispose of assets for the purpose of acquiring other assets or to incur debt for the same purpose. A holder of cash or short-term marketable debt which may be sold or easily redeemed

with little sacrifice is able to generate a demand for goods by spending or lending.

Time moves faster than debt management decisions and, without continuous effort and some leadership of the market, excessive liquidity is injected into the economy through large floating debt. This factor also bears upon the technical problem of management of the debt and the latitude for effective monetary policy. If it were practicable to establish and equalize quarterly maturities, with a relatively small floating debt, and thereby develop a roughly uniform term structure of the debt, administrative and technical problems would be greatly simplified and monetary policy probably made more effective. Liquidity needs in a significant sense could then be better adjusted by the Federal Reserve. Such a general framework would seem best to provide a successful operating atmosphere in which the joint obligations of debt management and monetary policy can be met with the best results.

On the whole, policies designed to deal satisfactorily with inflation and deflation must continue to evolve programs for action which will produce the best end product. The question of what regulates the relationship between goods and money, causing prices to rise and fall, is one of fundamental importance in any society and becomes increasingly significant in the degree to which the division of labor and capitalistic organization of production separate producer from consumer. In pursuing various economic objectives, monetary policy to be most effective must be accompanied by other appropriate measures of public policy.

APPENDIX

HARRY FLOOD BYRD, VA., CHAIRMAN

ROBERT S. KERR, OKLA. EDWARD MARTIN, PA.
J. ALLEN FREAR, JR., DEL. JOHN J. WILLIAMS, DEL.
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ELIZABETH B. SPRINGER, CHIEF CLERK

United States Senate

COMMITTEE ON FINANCE

February 17, 1958

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FEDERAL RESERVE BANK
OF CLEVELAND

Mr. W. D. Fulton
President, Federal Reserve Bank of Cleveland
Cleveland, Ohio

Dear Mr. Fulton:

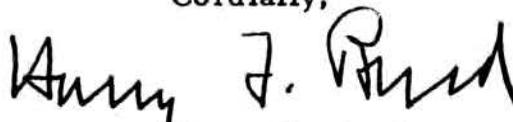
As you know the Senate Finance Committee has undertaken an inquiry entitled "Investigation of the Financial Condition of the United States." We have had testimony from three witnesses so far: former Secretary of the Treasury, George M. Humphrey; former Under-Secretary of the Treasury, W. Randolph Burgess; and Federal Reserve Board Chairman, William McChesney Martin, Jr. Under separate cover I am sending to you a copy of these hearings.

I am anxious that the Finance Committee have available for study and guidance your thoughts and opinions about vital matters affecting our economy. In preparing your reply it is suggested that you use the attached list of questions merely as a guide. Please feel free to answer part or all of the questions and make any further comments you deem desirable or appropriate.

For your information I am also addressing a similar letter to the individuals shown on the attached list. It is my present intention to recommend to the Finance Committee that the answers to this letter be compiled into a compendium for use by the members of Congress.

We must have a strong and sound economy to undergird our continued progress as a free nation. Your cooperation in answering these questions and adding your further comments will be a valuable contribution. I will appreciate your getting your answers and comments to me by April 1, 1958 if at all possible. In the event you will not be able to furnish your answers by that date, it would be most helpful if you would kindly indicate an approximate date when you could conveniently furnish your answers and comments.

Cordially,



Harry F. Byrd
Chairman

1. Give a definition in your own words of deflation and inflation.
2. Explain how you believe the economy of the United States can best avoid either inflation or deflation. If you think present laws should be changed or new laws are required, then make specific suggestions.
3. Comment generally on the monetary control policies of the Federal Reserve System as exercised within the following years: 1942 to 1957. (You may wish to divide the period into two parts, 1942-1950 prior to the accord, and 1951-1957.)
4. Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar.
5. What effect does the management of the current Public Debt have upon the national credit structure and the economy of the United States?
6. (a) Discuss in their relationship to one another and according to your judgment of their relative importance, the following three objectives of economic policy in the United States:
 1. Price Stability
 2. Stability of production, demand, and employment
 3. Economic growth in production, demand, and employment
- (b) With respect to these three objectives, discuss and appraise the significance of what you consider to be the most important trends since World War II--during the most recent two or three years--and especially during 1957.
7. Give your opinion of the effect on our economy of current Federal, State, and local Government spending.
8. Give your opinion of the effect on our economy of current Federal, State and local taxation.
9. Will you distinguish between fiscal policy (embracing expenditures, taxes and debt) and monetary and credit policy, and then relate them, one to the other. Please discuss these policies stating how they may be used to restrain inflationary trends and otherwise aid in preserving a stable economy.

10. (a) Comment generally on the adequacy or inadequacy of the United States Monetary System. (For the purpose of this question consider that the monetary system includes bank deposits and bank credits). Also please furnish your ideas for the correction of any inadequacies that you feel now exist in our monetary system.

(b) Comment briefly on the adequacy or inadequacy of the United States fiscal system.
11. (a) What is the explanation of the seeming paradox that at times inflation and unemployment exist side by side in our economy.

(b) Shall we accept, as some have suggested, a gradual inflationary trend as desirable (or necessary) to achieve and maintain full employment goals?
12. To what extent and in what way do you believe that the growth of private debt in recent years may have become a threat to the stability and vitality of the American economy.
13. Considering the financial condition of the United States, at what point, if any, in terms of unemployment, production, and consumer demand, should the Federal Government move in major ways, such as a tax cut and/or large increases in public works, to counteract a downturn in the economy.
14. How much of a factor in your opinion has deficit spending by the Federal Government since the end of World War II been in contributing to or producing inflation?
15. Can full employment goals be attained while maintaining a dollar that has relative stable purchasing power?
16. Are escalator provisions in wage or other contracts compatible with achieving economic stability?
17. List and briefly discuss what you consider the causes of the present recession, and what should be done to terminate it.