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Looking into the Eyes of a Giant

Discount Policy and the Discount Rate

Operations of the Bank

*Annual
Report
Issue*

LOOKING INTO THE EYES OF A GIANT



The year 1958 will be remembered by people for various reasons. Business news was bad and good. The sharpest but shortest postwar recession came to an end. Automobile sales were slower than in any peacetime year since 1948; longer, lower, chromier, and “finnier” lost some of their magic. Business spending on plant and equipment declined sharply and cast doubt on the new theory that such expenditures were oblivious to short-run changes in business conditions. But housing starts, declining since 1955, turned up and with gains in spending for highways, schools, and

other institutions carried total construction expenditures to new high levels.

Perhaps, however, in the longer view, 1958 will be remembered as the year when Americans became aware that a new industrial competitor was on the scene. The chart on page 5 tells the story. It is not a new story.

For quite some time now, most of us have been aware that Russia is growing industrially more rapidly than the United States. Our apprehensions, however, have been soothed by a number of palliatives: (1) statistics from Russia are of

questionable validity; (2) while rate of growth has been rapid the Russian totals are relatively small; (3) our educational system insures technological superiority even when crude production totals are challenged.

Over the course of the past year these palliatives have paled somewhat. In November, Mr. Khrushchev proclaimed a vast expansion program calculated to cut deeply into the United States lead in production by 1965 and surpass it by 1970. Many Americans visited Russia in 1958. Groups studying Russian industry generally attested to the vigor and growth of the Russian productive system. Academicians came back amazed at the depth and breadth of their educational system.

These reports focus attention on economic growth in this country. It is likely that in 1959, and for some time thereafter, economic growth will be a subject studied intensively.

This article cannot cover all factors and forces that underlie growth. It will, however, discuss some of the forces that may influence the size of the economy in 1959 in particular, and the near future in general. In this way, possibly a little light may be shed on the broader, general subject of economic growth.

Some growth comes naturally

Long-run economic growth is something Americans take for granted. It is not something we've had to worry over, plan for, or even think about. It has come naturally and abundantly.

For these reasons, perhaps, inquiries into growth seem concerned mostly with characteristics. They are static and statistical. They project, from present birth rates and marriage rates, population totals for 1965 or 1970 or 1975. From these projections we are told that in those years there will be a market for x number of shoes, automo-

biles, television sets, houses, and T-bone steaks; or Gross National Product is projected by taking the average increase per year for the past 50, 25, or 10 years and applying it to the future. Similar means are used to project personal income, industrial production, and a host of other measures.

The long-run, of course, is made up of a series of short-runs. Shorter-term growth also is frequently treated statistically. Budget documents of governments are analyzed for clues to next year's spending. Surveys are conducted to find capital spending plans of businessmen, how many houses builders will start, and what consumers are planning in the way of major purchases.

Deeper, sometimes hidden forces affecting short-term growth have not been so exhaustively investigated. We've measured the giant's footsteps but seldom looked into his eyes. We have more or less assumed that growth will naturally evolve out of our happy combination of abundant raw materials, large and growing population, and capitalistic system.

Now, however, the times seem to demand that we look into the eyes of the giant—that is, growth. The Soviet Union is and has been growing more rapidly; so mere measurement of our own strides yields discouraging conclusions if projected far enough into the future. In addition, at the very time that this country is becoming concerned about growth, our growth rate seems to have slowed.

Causes for growth are hard to find

It is not difficult to find the forces that make for growth in a political dictatorship and Socialist economy like Russia's. Growth is planned. Broadly, the Government decides how much of total product should go to the armed services, capital equipment, and consumers. More specifically, industrial leaders are told what and how

much to produce. Resources are allocated so that, in theory at least, they can accomplish these goals. Workers are told where to work, how much pay they will receive, and what they may buy. To some extent this works, but it is a brown, drab kind of a society that emerges.

Under our political and economic structure, it is much more difficult to find the forces making for growth, even in the short term. At times our economy appears to be liberated from any systematic causation. But mostly, there seems a kind of invisible world of cause and effect, mysterious, full of surprises, yet implacable in its course. It is necessary, therefore, to probe beyond the particular scenes and characters for the hidden laws, for the place where the forces take shape, for the rock upon which our economy rests.

The above paragraph may seem to make the

American political economy sound unnecessarily complicated. For this reason the following more tangible evidence is added.

Not too long ago the emphasis was on the volume of investment or business spending as a determinant of economic growth. Consumer spending was a function of income; people would spend a predictable portion of their income—the propensity to consume was fixed. Government spending policies were to be determined with these “truths” as a cornerstone. New theories, maxims, and laws were influenced by them. In other words, investment spending was an independent variable; consumer spending was a dependent variable.

More recently this theory has been modified by events. The boom in consumer spending in 1955, it is now said, touched off the boom in investment spending in 1956 and 1957. The sluggishness of consumer spending in 1956 and 1957 gets primary responsibility for the decline in investment spending in 1958.

Without pursuing this further, it is now commonly believed that to a large extent the various sectors of our economy are interdependent. Business spending depends on consumer spending, and on what business thinks the consumer will spend, and on what government spends, and on what business thinks government will spend in case of an economic setback.

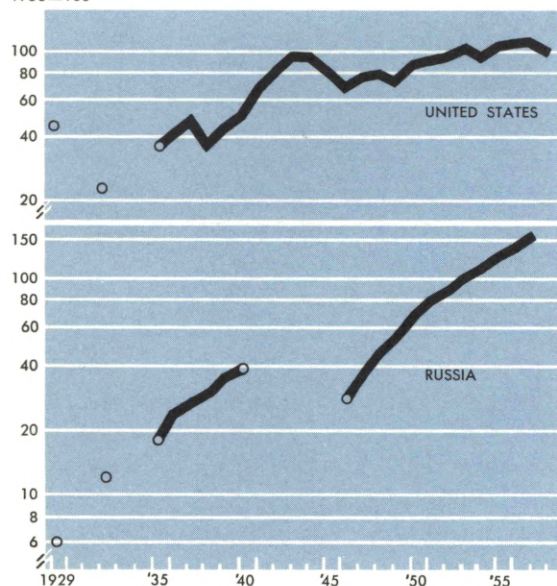
Consumer spending is influenced by the level of business and government spending. It is also influenced by expectations—expectations concerning future business spending, jobs or the lack thereof, and potential government policies in the event of a business downturn.

Government spending turns on defense needs, welfare benefits, farm prices, the level of unemployment—which of course is influenced by business and consumer spending—and how much it

RUSSIAN INDUSTRY IS GROWING RAPIDLY

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1953=100



is decided to allocate to highways, schools, and other expenditures.

Thus, a change in spending in any one of the three big sectors of the economy might be expected to bring about changes in one or both of the other sectors. This is especially true in the business and consumer sectors—the private sector—of the economy. In these sectors, changes have consequences that should grow naturally out of the free, or relatively free, play of market forces.

Even this much over-simplified view of our economy in operation gives a notion of its vast complexities. One thing this should do in addition is to illustrate that we can't understand anything unless we understand its relations to its context. It is necessary to feel beyond the edges of things.

Feeling beyond the edges

A free or relatively free capitalistic economy is many-sided, mixed, and difficult to describe. We can measure, at any given time, how large it is; but we don't know how large it should be, or even could be. For this reason we never know exactly how fast the economy should grow or could grow.

We have used certain guideposts that purport to tell us if our rate of growth is appropriate. Unemployment and prices are two broad standards most frequently used. When unemployment increases or, if at a high level, decreases only very slowly, we assume growth is too slow. When prices rise, it is assumed the economy is running too fast and growth cannot be sustained. These guideposts have been useful. In themselves, however, they don't tell us enough.

They are like thermometers for the economy. They tell us what our temperature is; from this we are supposed to be able to tell what is wrong, but they don't say why it is wrong. Sometimes they don't even tell us what is wrong. For months

in late 1957 and early 1958, unemployment was increasing and prices were rising. The thermometers seemed to be making contradictory statements: (1) the economy was operating at an unsustainably rapid pace; (2) growth was much too slow. Quite obviously, our thermometers were "out of touch."

Well then, how can we know if anything is wrong, what is wrong, and why it is wrong? How can we know whether we are growing too slowly, or too fast, or whether in the long-run we would be better off not to be growing at all, for the moment?

A FUNDAMENTAL IMBALANCE

In our society, growth is not a smooth, automatic, predetermined process. Rather it comes in fits and jerks. At any given time some parts grow faster, some stand still, others decline. But in an economy where interdependence of the sectors is of such critical importance a kind of symmetry is required. Growth in certain sectors quite naturally calls for increases in certain other sectors of the economy. And, in fact, if this derived expansion does not develop, an imbalance is created which jeopardizes growth in each of the parts.

At present our economy seems to be somewhat out of balance, and this imbalance is jeopardizing or at least retarding growth. Fundamentally, the imbalance is revealed in our ability to produce more than we are willing to consume. This is not too unusual. In nearly every recession and its immediate aftermath, productive capacity outstrips demand. What is unusual is that this condition has persisted for more than a year now, and many analysts think it will persist to a degree for some time to come. If it does, it could be a drag slowing the rate of growth.

It is important, therefore, to examine closely

the causes of this imbalance. Uncovering these, it may be possible to suggest how the imbalance may affect the course of the economy in the near future.

A lopsided economy

There is current a popular explanation of how this imbalance came about. Briefly, it says that the disproportion is directly related to the preceding boom. It goes like this:

In late 1954 and on into 1955 there was a spectacular upswing in consumer demand. When operations in most industries neared capacity levels in 1955, business set out on a massive investment program that continued into 1956-57 in response to the upsurge in consumer demand that had taken place and to keep pace with expected growth. But the expected growth in consumer demand after 1955 did not develop, and the economy found itself with an overhang of excess capacity. Now the economy is faced with a situation in which demand has to "grow up" to present productive capacity.

This explanation begins to feel beyond the edges. It tells us something is wrong—the growth rate is stunted; and why it is wrong—the economy is out of balance due to a lopsided boom. But it doesn't say why the boom was lopsided. Why did consumer spending fail to live up to the promises implied in 1955?

In 1955, total consumer spending was rebounding from the recession of 1954. It increased by nearly \$19 billion. In 1956, it rose by \$12.5 billion and in 1957 by \$15 billion. Final figures for 1958 are not yet available but it looks as though spending will have increased by about \$6 billion. Prices were fairly stable in 1955, however, and rose in subsequent years. If spending figures are adjusted for changes in the value of the dollar, the changes read: up \$18 billion in 1955,

up \$8 billion in 1956, up \$7 billion in 1957, and about even in 1958.

Parenthetically, it should be mentioned that consumer spending for new housing is not included in the totals. Housing is treated as investment spending. In real terms, this type spending peaked in 1955 and slumped in 1956 and 1957. Unlike total consumer spending, it came back somewhat in 1958. Therefore, spending for housing, too, sustains the idea that demand was disappointing after 1955.

Getting inside the broad consumer spending total yields even more information. The charts on page 8 show that in real terms—correcting dollar totals for changes in price—spending for durables was down from 1955 levels in 1956 and 1957, and down sharply in 1958.

The picture is a little clearer now. What is sometimes called disappointing consumer spending subsequent to 1955, is largely disappointing consumer spending on durable goods. Much of the overhang of productive capacity that is a potential threat to growth is confined to the durable goods sector of the economy—confined, in other words, to automobiles, appliances, furniture, and allied industries.

So much for the facts and figures. They have helped to focus attention on the sources of the fundamental imbalance. But we should go further. We should ask, how might balance be restored and the economy's posture improved for growth?

Broadly, there are two ways to restore the balance. It can be restored by a substantial rise in spending by consumers for durables. Is this likely? Or it can be restored by a shift in spending and resources to meet other needs and demands of the economy. Is this likely?

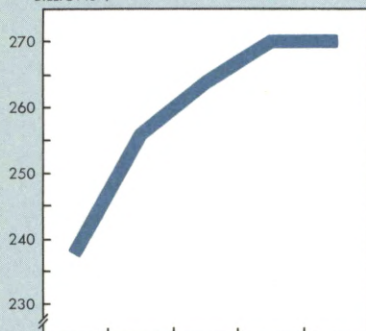
CONSUMER DURABLES UP?

Of course, it is impossible to say just what con-

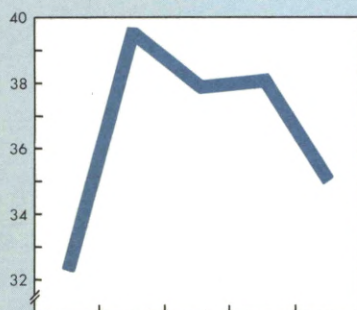
CONSUMER EXPENDITURES

In 1954 Dollars

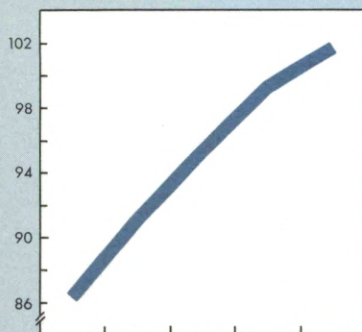
BILLIONS \$



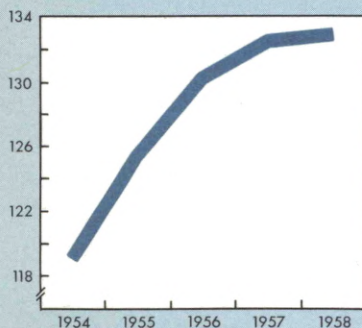
CONSUMER EXPENDITURES



DURABLES



SERVICES



NONDURABLES

sumers are going to spend for in 1959 and the near future. But if a projection is required, it is difficult to foresee a level of demand capable of absorbing all of the excess capacity. This is said, in part, because sales in 1955—it is demand levels in that year on which current productive capacity is predicated—were augmented by many nonrecurring special factors.

"One-shot pushes"

In 1955 much was said about "borrowing sales from the future." The automobile industry in particular was depicted as doing this. Automobile sales did fall far below 1955 levels in subsequent years. How much is there to this theory? Let's briefly review the situation.

Competition in the automobile industry probably hit a post-war peak in 1955. For a few years following World War II car sales seemed limited only by output. Each maker pretty much was able to sell all he could manufacture. By about 1949-1950 the situation began to change. But the change was obscured for a while by the Korean war, Regulation W, and material priorities. Competition returned in earnest in 1954. But Federal spending declined sharply, and the general business climate was not wholesome enough for a banner car-year.

In 1954, however, Ford showed Chevrolet it was a real challenger for the popularity championship which "Chevy" had held since 1931. It was apparent that each would resume the competition in 1955. They did. Others in the industry joined in.

Dealers were loaded—they said overloaded—with cars. They "wheeled and dealt" to get rid of them. Finance companies and banks were entreated to lower down payments and to stretch maturities. Dealers shaved their profit margins. Cars were sold. Factory sales hit an all-time peak

of 7.9 million units. Sales have not reached much beyond 6 million units since, and in 1958 reached about 4.2 million.

Were sales made in 1955 borrowed from future years? Yes — but not simply because too many cars were sold. They were borrowed largely because many things that happened in 1955 cannot occur each year.

Dealer protests against 1955 practices reached sympathetic ears in Congress. New franchise arrangements, more favorable to dealers, were negotiated. Dealers probably cannot be “loaded” with cars the way they were in 1955. Terms, stretched to 36 months in 1955, cannot be stretched indefinitely. They haven’t stretched since. Dealers can shave profit margins only so far—probably not beyond the shaving done in 1955.

What all this means is that automobile sales in 1955 got a lot of “one-shot pushes.” In retrospect, 1955 was an unusual year for car sales and it is probably unfortunate that capital spending plans in that industry and allied industries were influenced by what happened.

To some extent, what was said about automobiles in 1955 pertains to appliances. Competition among manufacturers was at a peak that year. This competition was reflected at the retail level. Discount houses achieved new prominence. Prices were cut at other retail establishments. Aggressive use was made of credit terms to sell products.

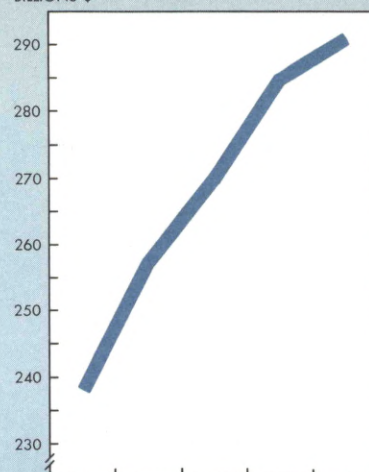
Derived demands still not satisfied

While the foregoing explains, in part, the reason for some caution about prospective demand for consumer durables it is not the whole story. If car sales in 1955 borrowed from 1956, 1957, and even 1958 totals, they surely won’t borrow from 1959. That’s stretching it out too far. But how many business analysts think 1959 is going to be

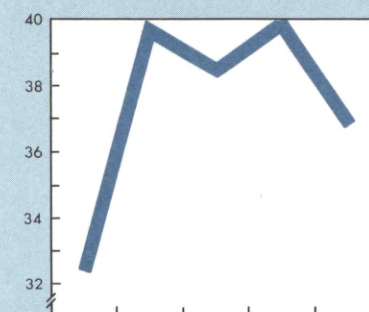
CONSUMER EXPENDITURES

In Current Dollars

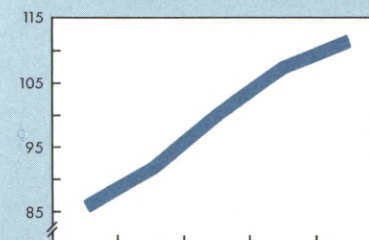
BILLIONS \$



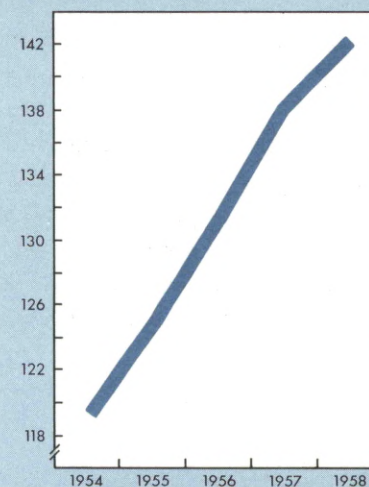
CONSUMER
EXPENDITURES



DURABLES



SERVICES



NONDURABLES

a banner car year? The post-war relationship of automobile sales to income and other factors suggests that more than 6½ million cars should be sold in 1959—even without “one-shot pushes.” But most forecasts put sales in the 5½ to 6 million range. What accounts for the disparity?

There is little agreement on an answer to this question. In general, however, there is agreement that consumers have become somewhat disenchanted with cars. It is said that the swing to smaller European cars is a measure of the disenchantment. Possibly, in addition to serving as a measure, the swing reveals a little about the origins of the disenchantment. It was said above that growth in our economy requires a certain symmetry. Growth in certain parts of the economy quite naturally calls for increases in certain other sectors of the economy.

Apply this to automobiles. In the postwar period a tremendous rise in the number of automobiles in use has occurred. In addition, their average size has increased by maybe one-third. This spectacular growth in number and size of automobiles calls for more service stations, repair shops, parking lots, mechanics, highways, traffic lights, and motorcycle police, among other things.

These “derived demands” called forth by more and larger cars have not all been satiated. Cars, in number and size, have outgrown some of their ancillary facilities.

Grumblings about inadequate parking facilities, bumper-to-bumper traffic, and huge repair bills are heard everywhere. It was amusing when postwar cars protruded beyond prewar garages—it was even fashionable. But the laughing has stopped. Power steering helps, but it is still hard to park a postwar car in a prewar parking lot. Automatic shift helps, but it's still frustrating to crawl along in bumper-to-bumper traffic with 300 horsepower under the hood. A general feeling of

disenchantment or dissatisfaction with automobiles quite naturally has developed. People seem to be less inclined to trade for a new car as long as the old one is adequate. When a new car is sought, they are likely to consider a smaller (foreign) car. It takes less space. It is an obvious way of protesting about the failure of streets to widen and parking lots to enlarge as cars have gotten bigger.

Automobiles are not the only consumer goods that seem to have outgrown some of their ancillary facilities. Appliances of all sorts are more numerous and complicated. Repair and service facilities for our tricky gadgets have not kept pace.

Suburbs filled with new houses have sprouted in what were formerly rural and semi-rural areas. Department stores, banks, supermarkets, and car washes have moved to the suburbs with consumers. But some suburban schools are overcrowded, water supplies inadequate and sewer pipes non-existent.

Unsatisfied derived demands are probably causing some consumer discontent. The problem has developed out of the extremely rapid growth in purchases of cars, appliances, houses, and some other consumer items. It has not been possible to spend for everything at once. Now a relative slowing in the demand for these items will permit other spending to “catch up.”

The new consumer

Finally, there is a good reason to believe that other deep-seated forces are changing the pattern of consumer spending—changing it in a way that could affect growth in 1959 and the years immediately following.

In the period since 1946, consumer spending has emphasized automobiles, houses, and appliances. It has been said that there is no other coun-

try in the world in which it is more difficult to guess one's income from his consumption pattern. Everybody has seemed to want and be able to buy substantially the same things. Of course, the wealthier tend to buy better cars, television sets, and wife-saving kitchen and laundry appliances—but almost everyone has them.

This pattern of demand is explained, in large part, by the virtual dearth in the output of these items during the war years. In addition, from 1932 to about 1950 (and particularly from 1940 to 1950) there was a great leveling trend in incomes. From the war period onward, this leveling took the form of a leveling upward. The effect was to move a great many more families into the middle income range, enabling them to satisfy demands for durable goods.

Now, very slowly, the emphasis could be shifting away from these "standard luxuries." This is not to say that in 1959 and later years cars and appliances will sell poorly. It is to say, however, that over a period of years, spending on these items may form a somewhat smaller part of total spending.

What are the reasons for this shift in buying emphasis that could be taking shape?

There are a multitude of forces which influence consumer buying decisions. Trying to isolate those that are causing a shift in the composition of consumption is an ambitious if not impossible undertaking. What follows can be nothing more than a presentation of a few factors and forces that might be causing spending patterns to be altered.

History tells us that there has been a more or less continuous trend toward increasingly complex living patterns. As a society becomes wealthier and more knowledgeable, its members tend to reach out for new ways to enrich their lives. Americans, wealthier now and better educated,

possibly have arrived at a "reaching out" point. Conspicuous consumption of "standard luxuries" doesn't provide all the satisfactions sought. Living patterns are beginning to catch up with money incomes.

Changes in the age composition of our population are also tending to alter buying patterns. Between 1957 and 1965 the number of people in the 25-44 year old category is expected to decline somewhat. This age group emphasizes spending for houses, cars, and home appliances. As this age group becomes a smaller part of the total population, the pattern of spending will veer away from its area of emphasis.

In addition, most consumers are well stocked with durable goods, and consumer debt is fairly high. This combination of factors tends to change the direction of spending.

RESTORING THE BALANCE

These have been background forces which will militate against a sharp upsurge in demand for durables. To repeat, this does not mean that demand for durables will stay at 1958 levels—1958 was a year of recession. Durables will bounce back. But they won't bounce so high as might have been expected from what happened in 1955. Excess capacity will not all be absorbed.

Other areas of spending will have to lead the economy if substantial growth is to be attained. All of these other areas of spending have not emerged clearly as yet. It may be possible, however, to sketch the dim outlines of the direction of the new spending emphasis.

Teenagers are forming the fastest growing age segment of our population. This will continue into the near future. Spending in our economy can't help being bent somewhat by this bulge in the population. Teenagers love ice skating, popular records, swimming, soda pop, boating, food, and

bowling, among other things. Spending associated with these teenage likes should benefit.

Oldsters over 65 are the next fastest growing segment of our population. Their spending tendencies should carry more weight in the total economy, too. They emphasize travel, vacation, hobbies, medical care, books, and the theater.

In addition, the topping out of the boom in spending for "standard luxuries" will lead to an intensive search for new products. Business will probably spend more for basic research for new products to tempt the new sophisticated consumer. Companies that stand pat are going to get a smaller share of the consumer's dollar.

Spending for education may increase appreciably. The fast growing number of teenagers and other school-age children are putting emphasis on this spending. Also, spending by business on basic research should indirectly lead to emphasis on education. Finally, Federal Government spending seems to be evolving away from spending on "military hardware" and toward emphasis on basic technology. This trend, too, tends to make for more spending on education.

The large number of cars on our roads, and the changes they have brought in our living habits, mean that highways, bridges, parking areas, and drive-in facilities are areas of potential increases in spending. Residents of many of our new suburban developments need more adequate water and sewage facilities, and larger schools.

To put it briefly, our economy is not wanting for areas of promise and potential growth. But in order to take advantage of this change in the direction of spending, certain fundamental changes in the allocation of our resources have to take place. We need flexibility in our productive resources. These resources must be responsive to changes in our desires and needs.

Of course, in a modern industrial economy like

ours, resources do not shift smoothly into and out of areas of greater and lesser demand. If our productive resources prove rigid and incapable of smooth shifting this could slow growth as we move into this period of change.

Inhibiting a smooth shift

It is not possible to be precise about shifting resources. But it is possible to say that relative changes in prices and profits have a great deal to do with the flow of resources. Theory has it that an increase in demand for a product tends to cause the price of the product to rise. A rising price brings a higher profit. Resources, then, tend to flow in the direction of rising prices and profits. At present, prices and probably profits, too, are distorted in a way that tends to nullify theory. Large differences in the size of the corporate units characteristic of our various industries, in part, cause this distortion.

In some industries large size is a real advantage. It enables the use of huge cost-cutting machinery and mass-production methods. In other industries there is little or no advantage deriving from ultra-large size. As a consequence, some industries are characterized by a few firms that account for all or nearly all of the activity. Other lines of business have numerous small firms each contributing a rather small share to total output.

When industries characterized by a few large firms suffer declines in demand they do not necessarily reduce prices. In some cases prices have risen in the face of declines in demand.

Industries in which a fairly large number of firms is characteristic seem to have more of a tendency to behave according to theory. Declines in demand seem more apt to bring declines in prices.

In addition, price and profit distortions may grow out of differences in economic power held

by the various industries. Frequently, industries in which there are only a few large firms will seem to “swing more weight” in our economy. This is natural enough. Firms in these industries are larger, better known, and make news more readily. For example, wage agreements arrived at by huge corporations bargaining with huge unions tend to set a pattern for all industry.

Wage rates in different industries have a certain relationship to each other. Increases granted in one sector often result in rises all along the line. If profit positions are to be protected, some of the wage rises can be granted only if accompanied by a rise in price. Industries with only a few large firms seem better able to “set” their prices.

What all this means is that our price system does not work in textbook fashion. Price relationships are distorted by the size and power of the various firms within different industries. These price distortions could inhibit a smooth flow of resources. These price distortions, therefore, could slow growth.

Not all spending comes naturally

A good part of the change in spending emphasis that is evolving will come naturally. As consumers we will probably emphasize spending for vacations, water sports, phonograph records, and soda pop, and relatively de-emphasize certain other kinds of spending. But increased spending for some other kinds of goods and services may not come about so readily.

Spending for highways, schools, water facilities, and sewage systems possibly needs to be increased if our economy is to grow rapidly. But this spending is done for consumers by a government body, usually a unit of state and local government. At the present time, however, funds for this kind of spending are hard to come by.

International tensions have produced defense requirements that demand high-level spending on the part of the Federal Government. Heavy spending for defense needs has caused the Government to take a large tax bite out of our total economy. Tax dollars remaining for other kinds of Government spending have been smaller as a result.

Spending on highways since 1946 has formed a smaller part of total spending than in the 1920's or the 1930's. Expenditures for sewage systems, water facilities, schools, and police protection are not receiving the attention they would receive if we didn't have to spend so much for defense needs.

International tensions have not abated. It is likely that tax dollars for these “housekeeping” functions of Government will continue relatively scarce.

It is unfortunate, too, that state and local units are sometimes so numerous and overlapping as to almost preclude efficient spending of funds. Most of our population growth since the war has occurred in our major metropolitan areas—97 per cent of the population increase from 1950 to 1955 took place in these areas. In some regions, new suburbs spring up in concentric rings until they collide with suburbs from the city beyond.

These booming suburbs are still divided politically into bits and pieces. One large metropolitan area frequently has hundreds of governmental units—counties, cities, townships, boroughs, villages, school districts, sanitation districts. The nation's 174 major metropolitan areas contain 15,658 governmental units. Some of these local governments are reluctant to give up even a part of their autonomy. Working in virtual isolation, it is difficult and uneconomic for a small segment of a large homogeneous area to solve its water supply, traffic, mass transportation, health, crime, and air-pollution problems.

Some metropolitan areas have achieved a high degree of cooperation, unity of action, and unity of planning among the governments within their borders. Economic growth in these areas has not been slowed by the multiplicity of governmental units. In other areas, however, growth has been inhibited.

The diseconomies which grow out of a fragmented approach to local government problem-solving are magnified by the aforementioned trends in total government spending. It is important that these diseconomies be minimized whenever possible. Our traditional institutions of government should accommodate themselves to current developments. Tax dollars must stretch to do the job.

Growth: Solidly based

Earlier it was said that no one knows how much growth should or could take place. Possibly, now we can say growth in 1959 will not be so large as it could be—could be if we weren't faced with the fundamental imbalance between capacity to produce and willingness to consume. But how large will it be?

Precise answers to this question have been given in numerous publications and speeches. No addition to the number will be made here. Suffice it to say that the economy will grow in 1959.

Possibly the increase in total spending will not be so large as in 1955 or 1950—other years of cyclical recovery. To some this will be disappointing. But remember that in each of these earlier years total spending was augmented by special factors. In 1955, it was the “one-shot pushes” already discussed; in 1950 the Korean war scare provoked a buying wave.

Actually, economic growth in 1959 could be more solidly based than was the case in 1955 or 1950. The statement is made not because recovery

will be slower in 1959. And it is made despite the fact that the basic imbalance may not be completely corrected 12 months hence. Recovery from each previous postwar recession was stimulated by random forces. Recovery in 1959 seems as though it will be based on deeper, longer-lasting forces moving through the economy. Ultimately, however, the veracity of this statement depends on the flexibility of our economy as it changes to meet new spending demands.

CONCLUSION

For most of our history the United States has seemed an exceptionally well-gifted economy—lots of land, natural resources, and business know-how. We've seemed so well gifted as to be blessed with an enormous margin for error. The country has been like an athlete so richly endowed that he can train very casually and still beat the opposition. This enviable position may not last much longer.

Industrial activity in the Soviet Union is growing rapidly. More growth is planned. Suddenly, we find ourselves in the position where possibly only our best will be good enough.

But how do we know when we are doing our best? How do we know whether the current level of economic growth is appropriate for our free society? Traditionally, we've looked at unemployment and prices as temperature gauges of economic activity. Recently these temperature gauges have been transmitting conflicting and confusing reports. Obviously, they are not the reliable indicators they once were. Changes in our political economy probably have rendered them less sensitive. They give sluggish and sometimes inaccurate indications.

This means we have to look beyond them and try to determine why growth is what it is, and what will influence growth in the near future.

Upon looking it appears that at present our growth rate is being slowed by a basic imbalance which exists between our capacity to produce and willingness to consume. This imbalance, pretty much, is confined to consumer durables and allied industries.

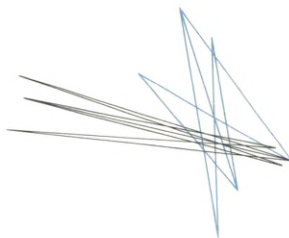
The imbalance can be cured by a sharp rise in demand for consumer durables or by a relative shift of resources toward new or growing segments of demand. There is little that suggests that consumers will get back to 1955-like buying of durables in the near future. A shift of resources with more emphasis on some of the areas of the economy that should grow faster seems to be in order.

There are a few important factors, however, that are tending to inhibit a smooth shift of resources. Some industries seem to "swing more weight" in our economy, largely because of vast differences in size of firms that characterize different industries. Industries in which there are a few large firms seem better able to maintain prices in the face of dramatic declines in demand. The allocation of resources, of course, is influ-

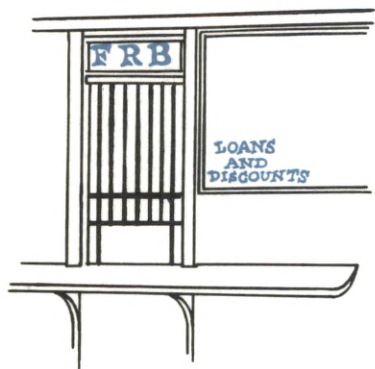
enced by prices and profits.

Highways, education, water facilities, and sewage systems are among the segments of the economy on which there seems to be an observable need for more spending. These are areas of government spending — mostly by state and local governments. The high level of spending and taxing for defense needs that arise out of international tensions make it difficult to get more funds for these "housekeeping" purposes. Unfortunately, too, sometimes the multiplicity of local units of government and their unilateral actions preclude the efficient spending of funds.

Despite these problems, 1959 will probably be a year of rising business activity. And what is more, the start we make in 1959 possibly may be more solidly based than in 1950 or 1955 — the years following our other two postwar recessions. This will be true if our economy is able to develop greater flexibility in its productive resources. Ultimately, it is change which unleashes the forces of growth within a free society. Growth will depend, in part, on how well our economic system responds to change.



DISCOUNT RATE AND THE DISCOUNT POLICY



In 1958, member-bank borrowing from the Reserve Banks declined as conditions in the money market became easier. Daily average borrowings reached a low of about \$100 million in July, and then rose as business activity improved and the money market tightened. There were five changes in the discount rate—three reductions in the first half and two increases in the latter part of the year.

Discount policy refers to the conditions governing discounting and borrowing from the Reserve Banks. It establishes the framework within which member banks may have access to Reserve Bank credit. The discount rate is a means of influencing the willingness of member banks to use the access to Reserve Bank credit afforded them by discount policy.

Both discount policy and the discount rate played prominent roles in the early history of the Federal Reserve System. Their importance waned in the thirties, however, as an inflow of gold and a weak demand for credit resulted in banks accumulating large excess reserves. During World War II and the early postwar period, the policy

of supporting the prices of Government securities, particularly the $\frac{3}{8}$ per cent rate on Treasury bills, gave member banks ready access to Reserve Bank credit. Thus, for almost two decades, little use was made of the discount window.

The importance of discount policy and the discount rate re-emerged following termination in 1951 of the policy of supporting the prices of Government securities. Member banks turned to the discount window in increasing numbers to obtain funds to cover reserve deficiencies. The discount rate regained a position of importance as an instrument of monetary policy, although not the preeminence of earlier years.

The revival of interest in discount policy and the discount rate has stimulated questions as to their significance and as to their use. This article deals with three related questions: (1) Why do member banks sometimes borrow from the Reserve Bank? (2) When is borrowing from the Reserve Bank appropriate and when is it inappropriate? (3) What are the effects of a change in the discount rate?

WHY MEMBER BANKS NEED TO BORROW

We all have the problem of keeping enough cash on hand or having ready access to cash sufficient to meet current payments. Sometimes cash receipts exceed, at other times fall short of expenses. To be in a position to meet expenses, therefore, we have to accumulate funds when receipts are larger than payments or borrow when our payments are larger than receipts.

Most individuals and business firms turn to commercial banks or to other financial institutions to balance out these short-run fluctuations in receipts and payments. The process of balancing short-run changes in receipts and expenditures thus tends to converge on commercial banks.

Factors affecting a bank's reserve position

Commercial banks are required by law to maintain a reserve equivalent to a prescribed minimum percentage of their deposits. Member banks of the Federal Reserve System are required to hold this minimum reserve in the form of deposits in a Reserve Bank.

A great variety of transactions affects a member bank's reserve balance and the deposits against which the reserve is held. Many checks are deposited in banks other than the banks on which the checks are drawn. Banks send these checks drawn on other banks through regular clearing channels for payment. If a bank has an adverse clearing balance, it loses funds to other banks; if the balance is favorable, it gains funds from other banks. A corporate depositor may authorize its bank to transfer a large sum to a bank in another city where additional funds are needed to meet expenses. The transfer, made over the Federal Reserve's wire transfer facilities, results in an immediate reduction in the sending bank's reserve balance and a corresponding in-

crease in the reserve balance of the receiving bank. Business firms and other depositors withdraw cash to meet payrolls and other needs. United States Treasury receipts and expenditures, which nowadays are in large volume, constantly shift funds among banks. These are only a few of the many transactions that result in daily changes in a bank's reserve balance and the volume of its deposits against which the reserve is held. As a result, a bank's reserve position—whether in excess or below the legal requirement—is constantly changing.

Even though many factors affect a bank's reserve position, certain patterns of behavior are frequently discernible. First, most banks experience sudden irregular shifts of only one or a few days duration. A bank may have a reserve deficiency one day, an excess the next. It is extremely difficult to anticipate these day-to-day changes with reasonable accuracy. Second, seasonal trends frequently result in an inflow of funds in one season and a persistent drain on reserves in another. Banks in agricultural areas, for example, usually have a substantial inflow of funds during the crop-marketing season. They lose funds as farmers draw on their deposit balances for living expenses and the costs of producing next year's crop. In resort areas, banks gain funds during the vacation season and lose funds in the off-season. Third, a bank's reserve position may reflect longer-term trends arising from its own policies. If a bank is expanding its loans and investments more rapidly than other banks in its market area, it is likely to suffer a persistent loss of funds through clearings. Banks expanding less rapidly, on the other hand, tend to gain reserves. Finally, regional differences in the rate of economic expansion and growth cause some banks to gain deposits and reserves, others to lose them. Crop failure, floods, or some other form of disaster

may drastically curtail economic activity and put local banks under severe reserve pressure.

Estimating the reserve position

Bankers have a profit incentive for keeping close tab on their reserve positions. A reserve balance in excess of the legal requirement earns no income; a deficiency incurs a penalty.

Certain features of the legal reserve requirement are especially important in managing a bank's reserve position. A member bank is not required to maintain a reserve balance equal to the specified percentages of its demand and time deposits *every* day. The requirement is in terms of *averages* over the computation period—of a bank's reserve balance each day and of daily totals of its demand and time deposits. (The reserve computation period is one week for member banks in central reserve and reserve cities, and semi-monthly for country member banks.) The reserve balance may drop below the required minimum for one or a few days, provided excess reserves on other days are sufficient to offset the deficits.

Another point is that certain deductions are allowed in computing the legal requirement against demand deposits. The two principal deductions are cash items in the process of collection and demand balances with other banks in the United States. The minimum percentage requirement is against net demand deposits, after deductions, not gross demand deposits.

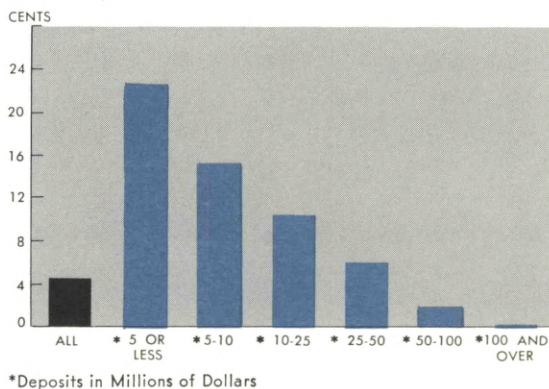
To facilitate estimating its reserve position, each member bank is supplied with a form with columns for entering total net demand deposits and total time deposits each day during the reserve computation period. The Reserve Bank sends each member bank a daily statement showing its actual reserve balance at the close of business that day. Most member banks receive this

statement the following day. By comparing the amount of reserve which would be required on the basis of net demand deposits and time deposits at the opening of business with the actual reserve balance at the close of business on the same day, a bank can determine with reasonable accuracy whether it is running a deficient or an excess reserve position.

Some member banks keep in closer touch with their reserve position than others. Large banks in financial centers watch their positions very closely to avoid having excess reserves that earn no income. They prepare estimates, as early in the morning as possible, of their reserve positions for the day. Most of them, on the basis of these estimates, make daily adjustments in their reserve positions, putting an excess into some income-producing asset or acquiring funds to cover a deficiency.

These large banks usually try to avoid having excess reserves. Their percentage of excess to required reserves is quite small. Smaller banks hold much larger percentages of excess to required reserves but the dollar amounts of their excesses are typically small. Small sums cannot be

NUMBER OF CENTS EXCESS PER DOLLAR OF REQUIRED RESERVES, BY SIZE GROUPS OF MEMBER BANKS, THIRD DISTRICT
First Half November 1958



employed in the money market so easily and profitably as large amounts. It is not so convenient for many of the small banks located some distance from a money market to make daily adjustments in their reserve positions. For these and other reasons, officials of many small banks maintain a cushion of excess reserves to avoid a deficiency.

Alternative media for adjusting reserves

Banks can use several methods to adjust their reserves. They can invest excess reserves in Treasury bills, commercial paper, or other securities; they can lend them temporarily to another bank or a securities dealer, or deposit them with a correspondent bank. To meet a reserve deficiency, a bank may liquidate securities, borrow the excess reserves of other banks, draw on its correspondent balance, or borrow from a Reserve Bank.

Bank preference is influenced by a number of factors. Treasury bills, other short-term securities, and commercial paper are commonly used as secondary reserves. Excess reserves so invested earn income and yet can readily be converted into cash with a minimum risk of capital loss when additional funds are needed. Short-term paper and securities are especially suitable for meeting seasonal and other longer-term reserve adjustments. Outright purchases and sales are not suitable, however, for daily or very short-term adjustments. For such adjustments, a bank may need to buy one day and sell the next. The spread between buying and selling prices absorbs most or all of the interest earned unless the securities are held at least two or three days.

The federal funds market—the borrowing and lending of excess reserve balances—has advantages for daily reserve adjustments. The bulk of these transactions is for one day, and there is no spread between buying and selling prices and

no risk of price change as in the case of short-term securities. Although the mechanics vary widely, the essence of a federal funds transaction is that a bank short of reserves borrows the excess reserves of another bank, agreeing to pay a specified rate of interest.

Because of its advantages for very short-term adjustments, the federal funds market has become widely used by the larger banks in financial centers to make daily adjustments in their reserve positions. The daily volume of transactions ranges from about one-half billion to over a billion dollars. The typical unit of trading is \$1 million; however, transactions for smaller amounts are frequently made, especially in periods of tight money. Banks with only small excesses or deficiencies are thus handicapped in using the federal funds market.

Member banks can borrow from a Reserve Bank to meet temporary reserve deficiencies, using subsequent excesses to repay the indebtedness; however, the Reserve Bank is not a profitable outlet for excess funds because excess reserve balances earn no income.

Relative cost is a significant influence in choosing among these reserve adjustment media. Banks naturally prefer to obtain funds as cheaply as possible. Normally, they will not borrow federal funds if they can borrow from the Reserve Bank at a cheaper rate. This explains why the federal funds rate rarely rises above the discount rate. Other influences are the attitude of bank management toward borrowing and toward such factors as the convenience of the different methods.

DISCOUNT POLICY

One of the functions of a central bank is to provide elasticity in a country's currency and credit to avoid seasonal and other temporary strains and stresses. This means supplying currency and re-

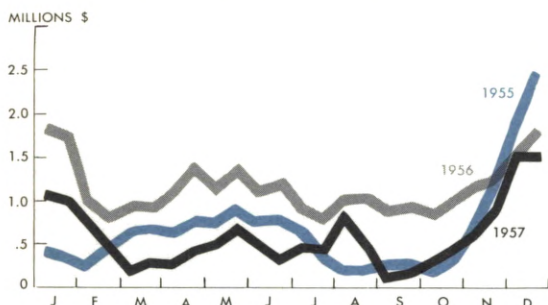
serves to meet the growing demands and absorbing currency and reserves during periods of seasonal slack.

Open-market operations are used to adjust the supply of reserves to the changing seasonal needs of the economy as a whole. For example, the Federal Reserve usually purchases Government securities in the latter part of the year to supply reserves absorbed by the outflow of currency into circulation and other seasonal factors; it reduces its holdings of Governments in the early part of the year to absorb some of the reserves created by the return flow of currency.

The discount window is more effective than open-market operations for meeting the seasonal reserve needs of particular banks or particular regions. Seasonal trends are not uniform for all banks. The peak needs of some banks may occur during a period of seasonal slack for the economy as a whole. Through the discount window, the Reserve Banks can supply reserves directly to the member banks which need them. Another advantage is that the reserves are supplied "with a string attached." Once the temporary need is over, the reserves are absorbed as member banks repay their indebtedness to the Reserve Banks.

Another important function of a central bank

**BORROWING FROM FEDERAL RESERVE BANK
BY COUNTRY MEMBER BANKS IN
AGRICULTURAL AREAS, THIRD DISTRICT**
Semi-Monthly Average of Daily Figures



is that of regulating the supply, availability, and cost of reserves and credit in such a way as to help keep the price level stable and to help maintain economic stability at high levels of production and employment. To achieve these objectives, a central bank must have effective control over the volume of reserves it creates. This means that access to the discount window may have to be limited; otherwise, the amount of reserves created would be at the initiative of member banks, not the central bank. In practice, access to central-bank credit has usually been limited in two principal ways: (a) by establishing certain conditions under which banks can borrow, and (b) by changing the discount rate, making it more or less expensive for them to borrow.

Historical development

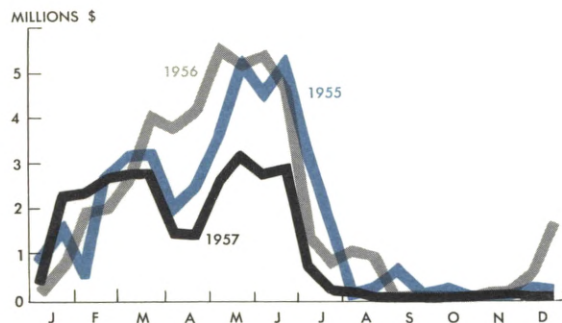
There has been a number of amendments to the provisions of the Federal Reserve Act relating to discounting and member-bank borrowing from the Reserve Bank; however, the principal developments in the philosophy of discount policy can be summarized briefly.

The dual nature of the discount function was recognized in the provisions of the Federal Reserve Act relating to the extension of credit to member banks. To provide the elasticity required in meeting seasonal and other temporary needs, the Federal Reserve Banks were given authority to discount commercial paper for member banks. Access to the discount window was limited, however, by making only certain types of paper eligible for discount.

Originally, the Federal Reserve Act defined eligible paper as notes, drafts, or bills of exchange maturing within 90 days (except agricultural paper which could have longer maturity) and drawn to provide funds for commercial, industrial, or agricultural purposes. Paper was ineli-

BORROWING FROM FEDERAL RESERVE BANK BY COUNTRY MEMBER BANKS IN RESORT AREAS, THIRD DISTRICT

Semi-Monthly Average of Daily Figures



gible for discount if the proceeds were to be used for speculative purposes, for fixed investment of any kind, or for the purpose of trading in securities except United States Government securities. In short, the philosophy of discount policy embodied in the Federal Reserve Act was that the Reserve Banks should extend credit to member banks only for short terms and for commercial, industrial, and agricultural purposes. It was also believed that by confining discounts to eligible paper, as defined, the quantity of Reserve Bank credit would adjust automatically to the varying needs of commercial and business activities.

Experience, especially in the thirties, revealed shortcomings in this early philosophy. Eligibility requirements proved ineffective in confining Reserve Bank credit to certain uses. Member banks discounted or borrowed against eligible paper to meet reserve deficiencies. The type of paper offered was no indication of the use made or to be made of the proceeds. Actually, discounts and advances supplied member banks with additional reserves. These reserves might be used for appropriate or inappropriate purposes.

A second difficulty was that eligibility requirements proved to be unduly restrictive at times.

The supply of eligible paper had been declining and was especially low during the crisis of the early thirties when deposit withdrawals were putting a heavy strain on the banks. The scarcity of eligible paper severely restricted the capacity of the Reserve Banks to issue Federal Reserve notes and to make discounts and advances to member banks. Finally, it became clear that eligibility requirements did not result automatically in a volume of reserves appropriate for maintaining stable prices and business stability at high levels of production and employment.

Current provisions

Experience led to significant revisions in the Act which broadened member-bank access to Reserve Bank credit. Member banks may now obtain credit directly from a Reserve Bank for short periods by: (a) discounting eligible commercial paper maturing in 90 days (except for agricultural paper which may have a maturity up to nine months); (b) borrowing on their own notes secured by eligible paper or Government securities; or (c) borrowing on their own notes secured by any other assets satisfactory to the Reserve Bank but at a rate $\frac{1}{2}$ per cent above the discount rate. As a matter of convenience, member banks obtain credit from the Reserve Banks almost entirely by borrowing on their own notes collateraled by Government securities.

The importance of administering the discount window in order to help maintain sound credit conditions was also recognized. Borrowing from a Reserve Bank was clearly established as a privilege, not a right. Section 4 as amended states that a Reserve Bank *may* extend to each member bank such discounts and advances "as may be safely and reasonably made with due regard for claims and demands of other member banks, the maintenance of sound credit conditions, and the

accommodation of commerce, industry, and agriculture.”

Furthermore, each Reserve Bank is directed to keep informed as to the general character and amount of loans and investments of its member banks to determine whether undue use is being made of bank credit for speculative purposes or for any other purpose inconsistent with the maintenance of sound credit conditions. In determining whether to grant or refuse credit to a member bank, the Reserve Bank shall give consideration to such information.

Finally, a Reserve Bank is to administer the discount window, as well as its other affairs, “fairly and impartially and without discrimination in favor of or against any member bank.” Authority was given to the Board of Governors to issue regulations further defining the conditions under which Reserve Bank credit is to be extended to member banks. The latest revision of Regulation A governing member-bank borrowing was made in 1955. The principal change was to put in a foreword to the regulation a statement of general principles governing Reserve Bank loans and discounts to member banks.

Appropriate borrowing

Many member banks have been able to manage their asset and reserve positions without having to borrow from a Reserve Bank. Over one-half of the member banks in this district have not borrowed since 1950.

It is not possible to pinpoint every case in which it is appropriate or inappropriate for a member bank to borrow from the Reserve Bank. One of the lessons of experience is that the discount window cannot be properly administered by mechanical rules. The conditions and needs which give rise to borrowing vary. Each must be considered on its own merits. There are certain

general principles, however, that serve as guides in administering Reserve Bank loans and discounts which can be summarized briefly.

Even the most prudently managed bank may experience reserve drains for a few days which occasionally reduce its daily average reserve balance below the legal minimum. Borrowing from the Reserve Bank is one way of meeting these short-term reserve deficiencies. Should the deficiency prove to be for a more extended period, borrowing gives the bank time to make such adjustments in its assets as may be necessary.

Unusual seasonal requirements are another case of appropriate borrowing from a Reserve Bank. Seasonal needs can be pretty well anticipated and prepared for so long as they conform to past experience. But deposit losses may be exceptionally heavy, loan demands unusually strong, or both. Secondary reserves may not be sufficient to meet such unexpected seasonal requirements. Member banks may rightly turn to the discount window for additional funds.

There may be occasions when it is appropriate for a member bank to borrow for a more extended period. Sometimes local or national emergencies put severe pressure on banks' liquid resources. Considerable time may be required to make the necessary adjustments and work out a solution. It is recognized that in such infrequent and unusual situations, borrowing for an extended period may be appropriate in order that a bank may better meet community needs.

Inappropriate borrowing

Many member banks borrow from a Reserve Bank only as a last resort. Few attempt to borrow for inappropriate purposes. Those instances usually arise from misunderstanding of the true function of the discount window. Final decision as to whether borrowing is inappropriate must take

into consideration the particular circumstances of the individual borrower. There are certain general types, however, which usually fall in the inappropriate category.

Borrowing to finance speculative activities—whether in securities, real estate, or commodities—is an inappropriate use of Reserve Bank credit. Paper drawn for such purposes has been ineligible for discount from the beginning of the System. Such use of Reserve Bank credit is undesirable from the standpoint of both the individual bank and monetary policy. Commercial bank officials have long frowned on loans to finance speculative activities. Experience has demonstrated that such loans are risky and all too frequently lead to financial difficulties. Even if safe for the individual lender, loans for purposes of speculation have a disruptive influence on the economy. Certainly, supplying member banks with reserves to support speculative loans is inconsistent with administering the discount window in such a way as to “maintain sound credit conditions” as provided in the Federal Reserve Act.

Borrowing to finance a member bank’s own investments is contrary to the spirit of the Federal Reserve Act. Investment is not a short-term, temporary need which bank management cannot reasonably anticipate. Borrowing to purchase securities for its own account is, in essence, an open-market operation conducted at the initiative of the member bank instead of the Federal Reserve System. Such borrowing, if widely practiced, would seriously impair Federal Reserve control over the supply of reserves and therefore its ability to regulate credit and the money supply in the interest of price and economic stability.

Similar in principle is borrowing from a Reserve Bank to avoid liquidating investments at a capital loss. Bank management in deciding to invest surplus funds in longer-term rather than

short maturities assumes the risk of incurring a larger capital loss should the securities have to be liquidated to meet expanding credit demands or other purposes. The inducement of a higher return on longer maturities should be weighed against the risk incurred. Extending credit to member banks to enable them to meet loan demands without liquidating investments is inconsistent with the Federal Reserve’s responsibility for “maintaining sound credit conditions.” This kind of discount policy would seriously weaken efforts to curb inflation during periods of strong credit demand.

Continuous borrowing, except in an emergency or some unusual situation, is also inconsistent with the principles embodied in the Federal Reserve Act. The purpose of the discount window is to make Reserve Bank credit directly available to member banks for temporary needs. Borrowing for a short period also gives a bank time to make such adjustments in its assets and lending policies as may be required in meeting longer-term requirements.

Borrowing from the Reserve Bank was never intended to be a source of capital to supplement a bank’s own resources. Even before the Federal Reserve System was formed, continuous borrowing from correspondent banks was frowned upon because experience had clearly demonstrated that a bank with a large debt was in a poor position to cope with hard times. Continuous borrowing, it should be noted, refers not only to consecutive days but also to consecutive reserve periods. A member bank borrowing \$7 million for one day increases its daily average reserve balance by the same amount as by borrowing \$1 million for seven days.

Borrowing to earn a rate differential or to gain a tax advantage are other purposes which are considered inappropriate.

THE DISCOUNT RATE

Discount policy is designed to promote sound banking practices and to maintain sound credit conditions. It establishes the framework within which member banks have direct access to Reserve Bank credit. The principles followed in administering the discount window do not change from recession to boom.

The discount rate, however, is one of the principal tools used in combating inflationary and recessionary tendencies. There are three principal channels through which changes in the discount rate may influence the volume of reserves, the cost of credit, and the flow of total spending.

The direct effect is to raise or lower the price of admission to the discount window. An increase in the discount rate makes it more expensive and tends to discourage member-bank borrowing; a reduction tends to have the opposite effects.

The cost effect of a change in the discount rate cannot be isolated from other factors influencing the volume of member-bank borrowing. Obviously, an important influence is whether conditions are such that banks feel the need for additional funds. Given such needs, cost is a factor influencing their willingness to borrow from the Reserve Banks. As the discount rate is increased, the rising cost of borrowed reserves is an incentive for bankers to screen their loan applications more carefully to reduce the need for borrowing. The discount rate, if raised high enough, can be a strong deterrent to obtaining additional reserves by borrowing from the Reserve Banks. On the other hand, a reduction in the discount rate tends to increase the willingness of banks to borrow so long as they need additional reserves. The discount rate is an essential but not in itself an adequate tool for regulating the supply of member-bank reserves.

The policy of a penalty rate, long adhered to by the Bank of England, is based on the cost effect of the discount rate. The objective is to keep the discount rate above the rates received by the borrower on its own loans and investments so that the central bank will be used only as the lender of last resort. In England this means keeping the Bank rate (the discount rate) above market yields on Treasury bills and short-term paper, which account for the bulk of the assets of the discount houses. Commercial banks in need of funds call some of their loans to the discount houses, forcing them to borrow from the Bank of England. The discount rates of the Reserve Banks have rarely, if ever, been used as a penalty rate in this sense. To serve as a real penalty rate, the discount rate would have to be higher than the rates received by member banks on the bulk of their loans and investments.

A second and more important channel is the influence of the discount rate on the whole structure of market rates. There is a close interrelationship between the discount rate and short-term market rates because the Reserve Banks and the money market are alternative media for adjusting cash and reserve positions. If the discount rate is above market rates on Treasury bills and other short-term securities, there is an incentive for banks to liquidate short-term investments instead of borrowing from the Reserve Bank. Increased liquidation of short-term securities tends to push short-term rates up to the discount rate. If the discount rate is below market rates, it is cheaper for member banks to borrow from the Reserve Banks than to obtain funds by liquidating securities in the market. The availability of reserves at the discount window at a lower rate, by diminishing the sale of securities, tends to lower short-term rates. The discount rate has little influence on market rates when reserves are

so plentiful that member banks do not need to borrow.

Changes in the discount rate, mainly through the more direct effect on short-term rates and expectations (which will be discussed later) also influence intermediate and long-term rates. A rise in short-term rates, for example, makes short maturities more attractive relative to intermediate and longer maturities. As investment funds are diverted into shorter maturities, intermediate and long-term rates tend to rise. Thus a change in the discount rate tends to be reflected in the entire structure of market rates, although the effect on the rates of shorter maturities is more direct and usually more pronounced. A change in the discount rate sometimes induces banks to make a similar change in their rates on customer loans.

The effect on market rates is one of the more important channels through which discount-rate action affects spending. The impact is likely to be greater on borrowing for capital expenditures than borrowing for working capital purposes. When long-term rates are relatively high and the bond market is weak, borrowers are more reluctant to float new bond issues to finance capital expenditures. There is a tendency to defer new offerings pending a more favorable market. Rising long-term market rates, by making bonds more attractive relative to mortgages, also tend to reduce the flow of funds into mortgages. Declining long-term rates, on the other hand, tend to stimulate the flow of funds into capital expenditures and mortgages.

The effect on expectations is a third channel through which changes in the discount rate may influence spending and the volume of business activity. The public tends to interpret a change in the discount rate as a signal of Federal Reserve credit policy. The reduction in the discount rate in November 1957 was an excellent illustration.

Developing recessionary tendencies had created uncertainty as to the future of business and interest rates. The reduction in the discount rate seemed to remove all doubt that the future course of interest rates was downward. As a result, investors and speculators moved promptly to increase their holdings of Government securities and other fixed income obligations. The shift in expectations was an important reason for the sharp decline in market rates.

The effect on spending and the volume of business activity is not so clearly discernible. A reduction in the discount rate, by inducing expectations of easier money and lower interest rates, may also result in more favorable anticipations with respect to the volume of business and tend to bolster spending. It may be interpreted, however, as an indication that Federal Reserve officials anticipate slackening business activity and the initial effect on spending may be adverse. Public reaction to a change in the discount rate is often capricious. The effect on expectations, therefore, cannot be accurately anticipated.

The role of the discount rate is such that a change does not always represent a change in Federal Reserve credit policy. It may be only a technical adjustment to bring the discount rate closer into line with market rates as a means of maintaining the existing degree of restraint or ease. If as a result of open-market policy, reserve availability relative to credit demands has lifted market rates above the discount rate, an increase in the latter may be required to maintain the existing degree of restraint. Otherwise, member banks would seek relief from the higher rates by borrowing at the discount window, thus relieving some of the pressure on the market and market rates.

The close interrelationship between open-market operations and the discount rate is the

reason use of these two instruments is coordinated. In a period of expansion, when the objective is one of restraint, open-market operations may be directed toward supplying less reserves than are needed to meet expanding credit demands, thus forcing member banks to obtain additional reserves by borrowing. The reluctance of many banks to be in debt to the Reserve Bank causes them to screen their loan applications more carefully. For maximum effectiveness, however, the discount rate should be kept close to or above market rates. When the objective is easier credit, the effect of reducing the discount rate can be substantially augmented by supplying enough reserves through open-market operations to reduce substantially member-bank indebtedness to the Reserve Banks.

IN CONCLUSION

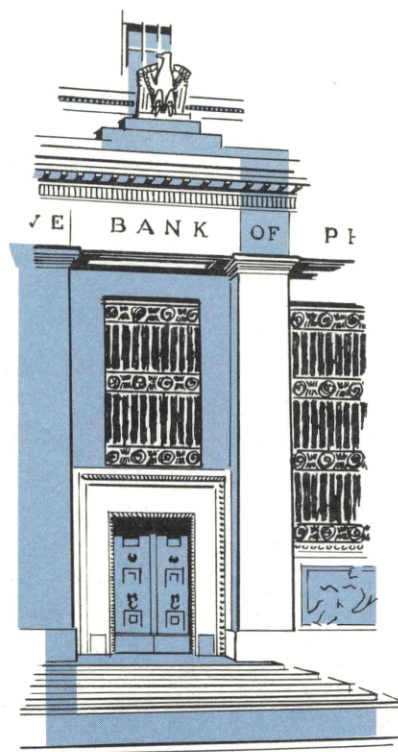
The principles underlying current discount policy and use of the discount rate developed from many years of experience both here and abroad. The discount window was the primary source of reserves, and the discount rate the primary instrument of monetary policy in the early years of the Federal Reserve System. Although open-market operations have since become the principal instrument for regulating the total supply of reserves, the discount window and the discount rate continue to play significant roles in Federal Reserve policy.

Reserve Bank loans to member banks make a significant contribution toward smoothing out the day-to-day and month-to-month stresses and strains generated by a multitude of business and

financial transactions which are constantly shifting funds among banks. As a means of meeting temporary reserve needs, such loans have the advantages of channeling reserves directly to the banks which need them, and with a string attached. Once the need is over, member banks repay their indebtedness and the reserves are extinguished.

Unlimited access to the discount window would be inconsistent with maintaining sound credit conditions and an effective monetary policy. Discount policy is designed to afford member banks ready access to reserves for temporary and emergency needs but without impairing the ability of the Federal Reserve to regulate reserves and the money supply in order to help maintain sustainable economic growth without inflation or deflation. If it were not for discount policy, the discount rate would probably have to be raised higher — perhaps much higher — in periods of strong credit demand to restrict sufficiently the availability of reserves to prevent excessive credit expansion. The result might well be a severe penalty on member banks needing to borrow to cover short-term deficiencies which could not reasonably be anticipated.

The discount rate, although not the preeminent tool of the early years of the Federal Reserve System, is an important instrument of monetary policy. Directly, it operates as a cost, influencing somewhat the willingness of member banks to borrow from the Reserve Banks. Indirectly, it affects the structure of market rates. Use of the discount rate and open-market operations are coordinated because each helps to make the other more effective.



OPERATIONS OF THE BANK

Less pressure on reserve positions was reflected in a sharp drop in the volume of credit extended to member banks—from a daily average of \$66 million in 1957 to \$13 million in 1958—although the number of borrowing banks declined only from 198 to 182. In line with a somewhat lower level of general business activity, the dollar volume of transactions also declined in several other departments of the Bank. Decreases were reported in checks handled, currency counted, clearing operations incident to direct sendings and wire and group clearings plans, the processing of postal receipt remittances, and in savings bond transactions. Substantial increases in transfers of funds handled by the Bank and in coins counted

were outstanding exceptions. Transactions in marketable Treasury securities also increased slightly in dollar volume, but not in number.

The non-official staff, including part-time employees, decreased from 1,056 to 997. This decrease was principally in the check collection department, due in part to discontinuance of part-time employees in the twilight force and a change in the issuance of Treasury checks which reduced the number of card checks processed here.

Many steps have been taken in past years to improve operating efficiency and the services rendered to banks and the Treasury. One of the latest innovations was the introduction of equipment to speed up and facilitate the inscription of

savings bonds. Possibilities for the use of more advanced equipment and electronic methods are constantly being explored, including active preparation for electronic check handling. Three committees—operations, training and rotation, and space—were set up early in 1958 to promote overall efficiency and flexibility. The operations committee acts in an advisory capacity on problems assigned to it that involve internal procedures. The development of employee capabilities and opportunities is the concern of the training and rotation committee. Effective utilization of space and the best placement of departments with respect to the flow of work and public contacts are the field of the committee on space.

Informational services and the maintenance of mutually rewarding relations with banks and the public continue to be one sector of the Bank's program. In part this involves the dissemination of data on current banking and business conditions and publications helpful to an understanding of Federal Reserve operations. Other facets include numerous addresses before business, banking, and educational groups; field meetings which reach bankers in all parts of the District; tours of the Bank; and the lending of films dealing with the Federal Reserve System.

Emergency planning

The Federal Reserve System has been charged with certain responsibilities in the development of

national security preparedness programs. These programs are designed to assure continuity of the nation's banking system and the maintenance and stabilization of the economy under emergency conditions.

Internal planning at this Bank for the re-establishment and conduct of essential operations under emergency conditions includes the daily dispatch of copies of vital records to a relocation office, the development of simplified manuals of operating procedure for use at that office, and the preparation of emergency operating circulars for distribution to all banks in the Third Federal Reserve District, and instructions to Third District banks selected to act as emergency agents of this Bank for certain functions. Discussions are being held with member banks and clearing house associations relative to the designation of check and cash agent banks.

The general program of emergency planning by individual commercial banks received added impetus this year by the distribution to all banks of five of a series of nine booklets on emergency planning to be published under the auspices of the National Committees on commercial bank preparedness. Greater emphasis is also being given in this District to such planning by state supervisory agencies and the various state, county, and local banking associations. As a part of this program, officers of this Bank have already addressed several associations on the subject.

DIRECTORS AND OFFICERS

The election of directors to serve for terms of three years from January 1, 1959 resulted in the election of O. Albert Johnson, President of the First National Bank of Eldred, Pennsylvania, by banks in Group 3 to serve as a Class A director, succeeding Lindley S. Hurff. Banks in Group 1 elected Frank R. Palmer, President of the Carpenter Steel Company, Reading, Pennsylvania, as a Class B director to succeed Charles E. Oakes.

The Board of Governors of the Federal Reserve System reappointed Henderson Supplee, Jr., as a Class C director of the Bank for a term of three years from January 1, 1959. Mr. Supplee will continue as Chairman of the Board and Federal Reserve Agent during 1959, and Lester V. Chandler as Deputy Chairman.

Casimir A. Sienkiewicz was reappointed by the Board of Directors of the Bank to represent the Third Federal Reserve District on the Federal Advisory Council during 1959.

Retirements over the past year included Alfred H. Williams, President of the Bank, W. J. Davis, First Vice President, and two Vice Presidents—William G. McCreedy and Ernest C. Hill. Karl R. Bopp was appointed President and Robert N. Hilkert, First Vice President. Other changes in the official staff are reflected in the list given on page 31.

DIRECTORS

AS OF JANUARY 1959

		Term expires December 31
Group	CLASS A	
1	GEOFFREY S. SMITH President, Girard Trust Corn Exchange Bank, Philadelphia, Pennsylvania	1959
2	WILLIAM B. BROSIUS President, National Bank of Chester County and Trust Company, West Chester, Pennsylvania	1960
3	O. ALBERT JOHNSON President, The First National Bank of Eldred, Eldred, Pennsylvania	1961
	CLASS B	
1	FRANK R. PALMER President, The Carpenter Steel Company, Reading, Pennsylvania	1961
2	R. RUSSELL PIPPIN Treasurer, E. I. du Pont de Nemours & Company, Wilmington, Delaware	1959
3	BAYARD L. ENGLAND President, Atlantic City Electric Company, Atlantic City, New Jersey	1960
	CLASS C	
	HENDERSON SUPPLEE, JR., Chairman President, The Atlantic Refining Company, Philadelphia, Pennsylvania	1961
	LESTER V. CHANDLER, Deputy Chairman Professor of Economics, Princeton University, Princeton, New Jersey	1959
	WALTER E. HOADLEY, JR. Treasurer, Armstrong Cork Company, Lancaster, Pennsylvania	1960

OFFICERS AS OF JANUARY 1959

KARL R. BOPP
President

ROBERT N. HILKERT
First Vice President

JOSEPH R. CAMPBELL
Vice President

WALLACE M. CATANACH
Vice President

DAVID P. EASTBURN
Vice President

MURDOCH K. GOODWIN
Vice President, General Counsel
and Assistant Secretary

PHILIP M. POORMAN
Vice President

JAMES V. VERGARI
Vice President and Cashier

RICHARD G. WILGUS
Vice President and Secretary

EVAN B. ALDERFER
Economic Adviser

CLAY J. ANDERSON
Economic Adviser

JOHN R. BUNTING, JR.
Business Economist

EDWARD A. AFF
Assistant Vice President

HUGH BARRIE
Assistant Vice President

NORMAN G. DASH
Assistant Vice President

ZELL G. FENNER
Assistant Vice President

GEORGE J. LAVIN
Assistant Vice President
and Assistant Secretary

HARRY W. ROEDER
Assistant Vice President

JOSEPH M. CASE
Chief Examiner

RALPH E. HAAS
Assistant Cashier

ROY HETHERINGTON
Assistant Cashier

WILLIAM A. JAMES
Personnel Officer

FRED A. MURRAY
Director of Plant

HENRY J. NELSON
Assistant Cashier

RUSSELL P. SUDDERS
Assistant Cashier

HERMAN B. HAFFNER
General Auditor

STATEMENT OF CONDITION

FEDERAL RESERVE BANK OF PHILADELPHIA

(000's omitted in dollar figures)	End of Year		
	1958	1957	1956
ASSETS			
Gold certificate reserves:			
Gold certificates.....	\$1,037,847	\$1,182,730	\$1,051,274
Redemption fund—Fed. Res. notes.....	60,195	60,901	63,053
Total gold certificate reserves.....	\$1,098,042	\$1,243,631	\$1,114,327
Fed. Res. notes of other Fed. Res. Banks.....	47,991	38,556	35,132
Other cash.....	16,950	15,057	13,116
Loans and securities:			
Discounts and advances.....	6,720	5,490	7,975
Industrial loans.....	—	173	439
United States Government securities.....	1,509,042	1,384,545	1,478,817
Total loans and securities.....	\$1,515,762	\$1,390,208	\$1,487,231
Due from foreign banks.....	1	1	2
Uncollected items.....	332,939	345,425	405,812
Bank premises.....	4,245	4,513	4,781
All other assets.....	8,181	12,740	14,885
Total assets.....	\$3,024,111	\$3,050,131	\$3,075,286
LIABILITIES			
Federal Reserve notes.....	\$1,751,391	\$1,738,756	\$1,756,490
Deposits:			
Member bank reserve accounts.....	863,417	874,740	859,677
United States Government.....	22,996	30,221	27,841
Foreign.....	16,215	23,870	21,312
Other deposits.....	4,013	12,955	16,865
Total deposits.....	\$ 906,641	\$ 941,786	\$ 925,695
Deferred availability items.....	275,287	279,334	306,868
All other liabilities.....	1,253	623	800
Total liabilities.....	\$2,934,572	\$2,960,499	\$2,989,853
CAPITAL ACCOUNTS			
Capital paid in.....	\$ 21,894	\$ 21,192	\$ 20,629
Surplus—Section 7.....	59,607*	55,923	52,301
Surplus—Section 13b.....	—	4,489	4,489
Reserves for contingencies.....	8,038	8,028	8,014
Total liabilities and capital accounts...	\$3,024,111	\$3,050,131	\$3,075,286
Ratio of gold certificate reserves to deposit and Federal Reserve note liabilities combined.....	41.3%	46.4%	41.5%
Commitments to make industrial advances...	—	\$26	\$15

* Includes \$291,000 transferred from Surplus—Section 13b in connection with repayment of \$4,198,000 advances previously received from U. S. Treasury under Section 13b of the Federal Reserve Act.

EARNINGS AND EXPENSES

FEDERAL RESERVE BANK OF PHILADELPHIA

(000's omitted)	1958	1957	1956
Earnings from:			
U. S. Government securities	\$42,317	\$43,036	\$34,351
Other sources	341	2,172	1,940
Total current earnings	\$42,658	\$45,208	\$36,291
Net expenses:			
Operating expenses*	\$ 6,810	\$ 6,494	\$ 6,294
Cost of Federal Reserve currency	210	211	293
Assessment for expenses of Board of Governors	408	528	383
Total net expenses	\$ 7,428	\$ 7,233	\$ 6,970
Current net earnings	\$35,230	\$37,975	\$29,321
Additions to current net earnings:			
Profits on sales of U. S. Government securities (net)	\$ 10	\$ 10	\$ 16
Reimbursement for fiscal agency expenses incurred in prior years	—	113	—
All other	—	—	—
Total additions	\$ 10	\$ 123	\$ 17
Deductions from current net earnings:			
Reserves for contingencies	\$ 10	\$ 14	\$ 16
Retirement System (adjustment for revised benefits)	—	604	—
All other	1	1	—
Total deductions	\$ 11	\$ 619	\$ 17
Net additions or deductions (—)	\$ —1	\$ —496	\$ —
Net earnings before payments to U. S. Treasury	\$35,229	\$37,479	\$29,321
Paid to U. S. Treasury (interest on Federal Reserve notes)	30,541	32,594	25,296
Dividends	1,294	1,263	1,215
Transferred to Surplus (Section 7)	\$ 3,393	\$ 3,622	\$ 2,811

* After deducting reimbursable or recoverable expenses.

VOLUME OF OPERATIONS

FEDERAL RESERVE BANK OF PHILADELPHIA

	1958	1957	1956
Number of pieces (000's omitted)			
Collections:			
Ordinary checks*	168,000	162,800	163,100
Government checks (paper and card)	26,400	46,600	44,200
Postal money orders (card)	19,700	21,900	23,600
Non-cash items	800	1,000	1,000
Clearing operations in connection with direct sendings and wire and group clearings plans**	792	864	940
Transfers of funds	119	115	106
Currency counted	303,100	314,600	304,900
Coins counted	511,500	425,000	395,900
Discounts and advances to member banks	1	2	3
Depository receipts for withheld taxes	492	486#	463
Postal receipts (remittances)	347	423	462
Fiscal agency activities:			
Marketable securities delivered or redeemed	334	345	213
Savings bond transactions— (Federal Reserve Bank and agents)			
Issues (including re-issues)	7,930	8,944	7,909
Redemptions	6,223	7,461	6,548
Coupons redeemed (Government and agencies)	941	906	789
Dollar amounts (000,000's omitted)			
Collections:			
Ordinary checks	\$61,100	\$63,206	\$60,927
Government checks (paper and card)	4,890	5,876	6,970
Postal money orders (card)	306	337	346
Non-cash items	140	156	190
Clearing operations in connection with direct sendings and wire and group clearings plans**	31,004	31,194	30,793
Transfers of funds	58,972	49,315	49,524
Currency counted	2,072	2,120	2,049
Coins counted	52	45	44
Discounts and advances to member banks	1,559	11,903	11,731
Depository receipts for withheld taxes	1,806	1,799	1,619
Postal receipts (remittances)	825	870	819
Fiscal agency activities:			
Marketable securities delivered or redeemed	10,832	10,798	8,035
Savings bond transactions— (Federal Reserve Bank and agents)			
Issues (including re-issues)	413	444	467
Redemptions	462	620	521
Coupons redeemed (Government and agencies)	112	101	93

* Checks handled in sealed packages counted as units.

** Debit and credit items.

Revised.

*Additional copies of this issue are available
upon request to the Department of Research,
Federal Reserve Bank of Philadelphia,
Philadelphia 1, Pa.*