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THE BUSINESS REVIEW

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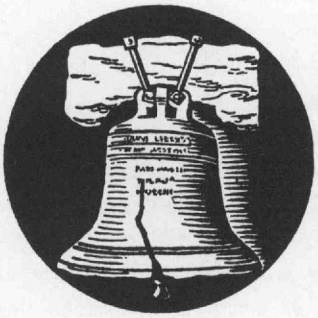

QUEST FOR STABILITY

The Employment Act of 1946 set up the objective of promoting maximum production and employment. Economic stability at high levels of employment has been a major goal of Federal Reserve policy. The primary guide to policy decisions at first was the quality of credit; then it shifted to the quantity of credit. Experience proved that rules could not take the place of judgment. This article, the second in a series of four, deals with the problem of developing operating guides and shows how goals desirable in themselves are often somewhat in conflict.

THE MONTH'S STATISTICS

Expansion in industrial production ended but building and construction continued at high levels. District lending to business turned upward.

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QUEST FOR STABILITY

Attempts to solve some of the monetary problems that have confronted us were traced in the February issue of the monthly* Business Review, *which contained the first of a series of four articles. The Federal Reserve System was established in 1913 in part to furnish an elastic currency so that banks could always meet cash withdrawals by their depositors, and in part to help iron out booms and depressions.

The Congress, in the Employment Act of 1946, has committed the Federal Government to the use of all practicable means to maintain economic stability at maximum employment. A Congressional committee, reporting under this Act, recently stated that monetary, credit, and fiscal policies should be employed as the primary method of achieving this objective, and placed full responsibility for monetary policy on the Federal Reserve System. How to translate such broad, general objectives into more specific guides which will be useful in adapting programs to the needs of specific situations has always been a major problem confronting Federal Reserve authorities.

An understanding of the objectives of Federal Reserve policies, by fostering a better spirit of public cooperation, can be an important contribution toward the effective functioning of the Federal Reserve System. This second article in the series deals with the problem of objectives; their importance as guides to action, how changing conditions influenced specific objectives, and how desirable objectives may be in conflict.

In the Employment Act of 1946, Congress set up the ultimate objective of economic stability in the following terms:

> ". . . it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy with the assistance and cooperation of industry, agriculture, labor, and state and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, *in a manner calculated to foster and promote free competitive enterprise* and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and *to promote maximum employment, production, and purchasing power.*" (Italics supplied.)

In this Act, Congress indicated clearly: (1) that the Federal Government is to coordinate all of its activities toward achieving stability at maximum employment and that other Governmental units and private enterprise were to cooperate and assist; and (2) that the methods used shall be such as will foster and promote free competitive enterprise.

The Joint Committee on the Economic Report was established in the Act to make studies, reports, and recommendations to further the policies of the Employment Act. The Subcommittee on Monetary, Credit, and Fiscal Policies, of which Senator Douglas is Chairman, recently recommended:

> ". . . not only that appropriate, vigorous, and *coordinated monetary, credit, and fiscal policies* be employed to promote the purposes of the Employment Act, but also that *such policies constitute the Government's primary and principal method of promoting those purposes.*" (Italics supplied.)

The Subcommittee recommended further:

> ". . . that an appropriate, flexible, and vigorous monetary policy, employed in coordination with fiscal and other policies, should be one of the principal methods used to achieve the purposes of the Employment Act . . . that the *primary power* and *responsibility* for *regulating the supply, availability, and cost of credit* in general *shall be vested in* the duly constituted authorities of *the Federal Reserve System* . . . " (Italics supplied.)

Thus the Federal Reserve System, which has the primary responsibility for monetary policy, is expected to play a

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major role in efforts to achieve the declared objective of maintaining economic stability at high levels of production and employment.

It is one thing to say that the Federal Reserve System should use its powers to promote general economic stability at high levels of employment, but it is quite another thing to set up practical standards which will accomplish this broader purpose. For example, should the System give primary attention to the quality or the quantity of credit, to price stability or general business stability? The nature and importance of selecting the proper intermediate goals can best be made clear, perhaps, by the light of experience.

EVOLUTION OF OBJECTIVES

The Federal Reserve Act of 1913, which established the Federal Reserve System, did not offer much guidance with respect to objectives and policy matters. It stated only that discount rates should be fixed "with a view of accommodating commerce and business." Accommodation of commerce and business, however, is subject to a variety of interpretations.

In its first Annual Report (1914), the Federal Reserve Board revealed a twofold objective. First, the Federal Reserve System should see that business could obtain credit at reasonable rates. When commerce, industry, or agriculture are "burdened unduly with excessive interest charges, it will be the clear and imperative duty of the Reserve Board, acting through the discount rate and open market powers, to secure a wider diffusion of credit facilities at reasonable rates." In the second place, the System should attempt to anticipate emergencies and protect business from the harmful effects of an excessive expansion or contraction of credit. "Its duty plainly is not to await emergencies but, by anticipation, to do what it can to prevent them. Only then will it constantly carry the promise of being able to protect business against the harmful stimulus and consequences of ill-advised expansions of credit, on the one hand, or against the menace of unnatural restrictions and unnecessary contractions, on the other, with exorbitant rates of interest and artificial stringencies." This was expressing the concept of stability in the language of that period. Maintaining stable business conditions has been a basic objective underlying Federal Reserve policy from the very beginning.

The gold standard and the Federal Reserve Banks' reserve ratios were sometimes mentioned as guides in adjusting the amount of credit to the needs of trade. Some favored varying the volume of Federal Reserve credit with changes in the gold reserve—an inflow of gold resulting in an expansion of credit, and an outflow in a contraction. Changes in the gold reserve and the reserve ratio have not been important guides to credit policy, however. Ordinarily actions have been taken on some other basis.

Accommodation of Business

The accommodation of business was one of the major considerations in early Federal Reserve policy decisions. In 1914, the Federal Reserve Board stated that the more complete adaptation of the credit mechanism to the needs of business and agriculture should be the constant aim of a Reserve Bank's management. As a step in this direction, the System tried to bring about a wider diffusion of credit facilities at reasonable rates of interest.

The objective of meeting the credit needs of business at a reasonable cost was reflected in the Board's policies after World War I. The removal of wartime restrictions released strong inflationary pressures, and the Board was confonted with an excessive expansion of credit. It recognized the need for checking credit expansion, but wanted to avoid the danger of precipitating a strong deflationary movement. The discount rate was the chief tool employed at that time, but the pressure of demand relative to the available supply of goods was so strong that a moderate rise in interest rates was not expected to be very effective in restricting the demand for credit. Moreover, to raise the general level of interest rates very high would be in conflict with the objective of making credit always available to meet the needs of business at reasonable rates.

The Board soon found that, under existing inflationary conditions, accommodating business at moderate rates was inconsistent with the goal of preventing excessive credit expansion. In an effort to resolve this conflict in objectives, the Board recommended that it be given authority to establish a maximum line of credit for each member bank according to a uniform rule. Member banks obtaining credit from the Federal Reserve in excess of this basic amount should be charged graduated rates ascending as the amount of borrowing exceeded the normal line established. The Board thought this method would make it possible to "reduce excessive borrowings of member banks and to induce them to hold their own large borrowers in check without raising the basic rate." In 1920, the Federal Reserve Act was amended permitting the Reserve Banks, with the approval of the Board, to establish graduated rates of discount. Graduated rates, except on loans against

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Government securities, were established by the Federal Reserve Banks in Kansas City, Dallas, St. Louis, and Atlanta but they were soon abandoned. If the Federal Reserve was to discourage or prevent excessive credit expansion and contraction, interest rates could not be held at some arbitrary level which might be considered reasonable. Thus, one of the early guides to System credit policies was soon proved to be inadequate and ineffective.

Proper Use of Credit

In the early 'twenties, emphasis shifted to the *quality* of credit as the primary guide for Federal Reserve credit policy. Excessive expansion or contraction could be avoided, it was thought, by limiting the use of credit to so-called legitimate business purposes. For over a decade after World War I there was a deep-rooted belief that the primary goal of Federal Reserve policy should be to limit the use of bank credit to short-term commercial paper originating in production and trade. This was a basic part of the philosophy incorporated in the Federal Reserve Act, member banks originally being permitted to obtain credit from the Reserve Banks only on the basis of eligible, short-term commercial paper. The Act stated that the definition of eligible paper "shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States."

In the Annual Report of 1923, the Board analyzed the problem of credit policy in considerable detail. The report pointed out that the administration of Federal Reserve credit required decisions both as to the quality and the quantity of credit. Although it was stated that both should serve as guides to credit policy, the proper *quality* of credit was regarded as the essence of the problem. Actually, the quantity of credit was not a determinant of policy until over a decade later.

The Board interpreted the qualitative standard as follows: "A characteristic of the good functioning of the economic system is to be found in the smooth, unobstructed movement of goods from the producer through the channels of distribution to their several ultimate uses. . . . So long as this flow is not interrupted by speculative interference, there is little likelihood of the abuse of credit supplied by the Federal Reserve Banks and consequently little danger of the undue creation of new credit. . . . But when the effect of the credit used is to impede or delay the forward movement of goods from producer to consumer, unless such delay is made necessary by some unavoidable cause, e.g., the interruption of transportation facilities, credit is not productively used. The withholding of goods from sale when there is a market or the accumulation of goods for an anticipated rise of price is not a productive use."

Drawing together the threads of thought expressed in this statement and in the Act, the productive use of credit was interpreted to include financing the production of goods and their normal flow through the channels of distribution to the consumer. Productive use of credit did not include financing (1) investment or speculation in securities or (2) withholding goods from the market or accumulation of inventories in anticipation of a price rise.

What about the quantity of credit? How could Federal Reserve authorities tell whether too much or too little credit was being extended? Actually, the problem was regarded as one of quality, not quantity. If the quality of credit could be maintained, the volume would pretty largely take care of itself. This point was well stated by the Board in the following terms: "The volume of credit will seldom be at variance with the volume of credit needs if they are reflected in the demands of productive industry as long as (1) the volume of trade, production, and employment and (2) the volume of consumption are in equilibrium. . . . It is the non-productive use of credit that breeds unwarranted increase in the volume of credit; it also gives rise to unnecessary maladjustment between the volume of production and the volume of consumption, and is followed by price and other economic disturbances."

So much for the principles established. How did these guides to credit policy work out in practice? The test was not long in coming. In 1925, the demand for business credit was relatively small and funds began to flow in volume to the money centers, where they were used to make loans to purchase or carry securities. The expansion of credit for speculative purposes in the late 'twenties became of increasing concern to Federal Reserve officials. The Board stated that it "neither assumes the right nor has it any disposition to set itself up as an arbiter of security speculation or values." The use of credit for speculative purposes was opposed, however, because it induced general overexpansion and inflation, and absorbed credit and raised interest rates to the detriment of business and agriculture.

The tests set up for maintaining the appropriate quality of credit were difficult to carry out in practice. Two types of administrative problems were encountered. First, it was

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difficult to determine the use made of Federal Reserve credit. Second, it was impossible to restrict credit for improper uses without making it scarcer and more expensive for business purposes also.

The Board soon realized the difficulties involved in limiting the use of Federal Reserve credit to productive purposes. Member banks borrowed or discounted commercial paper to make up deficiencies in their reserve accounts. Deficiencies occurred as the result of a variety of operations, some adding to and others subtracting from reserve balances. A deficiency in the reserve account could not be identified with any specific transaction. It was not possible, therefore, to control the use member banks made of Reserve Bank credit by turning down certain applications for loans or discounts.

The problem of determining the use to which member banks put Reserve Bank credit led the Board to draw a distinction between banking policy and credit policy. Banking policy had to do with the influence the System exerted over loans and investments of individual member banks. In granting credit, the Reserve Banks needed to look beyond the mere fact that member banks were required to offer eligible paper. They should be assured, in addition, that further credit could be granted safely and reasonably, and with due regard to the claims of other member banks. The objective of banking policy was to promote the soundness of the individual bank. In pursuit of this objective, the Board sent a letter to the Reserve Banks asking them not to permit the use of credit for speculative purposes. Credit policy, on the other hand, was impersonal and was directed toward influencing the volume and cost of credit.

Both banking and credit policy were directed toward checking the use of credit for speculation. They were not effective, however, as funds continued to flow into the securities market from both bank and nonbank sources.

The difficulties encountered by the Federal Reserve in attempting to prevent an excessive use of credit for speculation led to remedial legislation in 1933 and 1935. To prevent an inflow of funds from nonbank sources, member banks were forbidden to act as agents of corporations and individuals in making loans on securities. To prevent an excessive use of credit for speculation in securities, the Federal Reserve Board was given authority to fix margin requirements on security loans. The Board was also given the power to direct any member bank which was making too many loans for speculative purposes to refrain from increasing its loans on securities.

Experience in the late 'twenties greatly undermined confidence in the so-called commercial loan theory—that limiting credit to short-term commercial paper would automatically result in the appropriate quantity of credit. First, it was not administratively feasible—limiting the extension of Federal Reserve Bank credit to commercial paper did not result in a corresponding restriction on the use member banks made of the additional funds. Second, changing conditions required changes in methods of financing. The growing importance of plant and equipment expenditures, for example, was reflected in a demand for longer-term credit. The tendency was for banks to grant longer-term loans and to purchase or make loans on corporate securities. The amount of eligible short-term commercial paper was decreasing despite a growth in the total volume of business and the total demand for credit. A third weakness was that limiting the quantity of credit to the needs of business did not prevent excessive expansion or contraction. The war and post-World War I boom was built on commercial paper credit, and the shortage of commercial paper in the early 'thirties intensified the depression by limiting the access of member banks to Federal Reserve credit. Once full production is reached, the rise in the demand for credit is not automatically checked; instead, prices may rise, resulting in a larger dollar volume of business and enlarging further the demand for credit. This process of rising prices and expanding credit—always for business purposes—may continue until there is a disastrous inflationary boom. The opposite may occur on the downswing. Limiting the use of credit to purposes evidenced by short-term commercial paper is not an effective method of preventing either excessive expansion or contraction.

In fact, it was the shortage of eligible commercial paper in the early 'thirties which unduly restricted the access of member banks to Federal Reserve credit and led to the final abandonment of this objective of Federal Reserve policy. In order that member banks in sound condition could get additional currency and reserves as needed, the Federal Reserve Act was amended. United States Government securities as well as eligible paper were made eligible as collateral for the issue of Federal Reserve notes. In addition, the Federal Reserve Banks were authorized to lend to member banks on any assets the Federal Reserve Bank considered satisfactory. This provision of the Banking Act of 1935 marked the final abandonment of the commercial loan theory as a major guide, and marked a significant step toward the substitution of judgment for rules in the formulation of policy.

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General Business Stability

Conceptions and rules, such as the commercial loan theory, the accommodation of business and the reserve ratio were envisioned not as ultimate goals but as means of promoting a healthy economic system. As experience, however, proved them inadequate or false, attention was directed to prices, production, employment, the money supply, the quantity of credit, the securities market, and all other pertinent data which registered the status of our economic and financial health. With the help of such guides, decisions were made as to the type of Federal Reserve action needed to achieve stability.

In the early years of the System, the problem of achieving stability was envisaged primarily as one of checking booms. In 1921, looking forward to the return of prosperity, the Board stated: "If the flow of the incoming tide can be controlled so that the crest may not be reached too rapidly or rise too high, the subsequent reaction will be less severe." The policy to be followed during depression was the removal of restraints—not a positive program to stimulate credit expansion and recovery.

Gradually, however, the achievement of stability came to be visualized as requiring action not only to check booms but also to promote recovery from depression. In 1924 some of the Federal Reserve authorities favored action to try to lift business out of the recession of that year. Stimulating recovery did not become an important objective of Federal Reserve policy, however, until the severe depression in the early 'thirties. Since that time, a program for achieving general business stability has included action both to prevent inflation and to promote recovery from depression.

Periodically, the proposal is advanced that the System should contribute to economic stability by adopting a stable price level as the guide to policy. The Board, in its 1923 analysis of guides to Federal Reserve policy, raised several objections against this proposal. In the first place, price fluctuations result from a variety of causes, some of which were beyond the reach of Federal Reserve policy, which would mean that the System's efforts would be foredoomed to failure. Second, price movements are too late to serve as an effective guide. They are merely the end results of a series of market changes which have already taken place. They record an accomplished fact. Third, there is the technical difficulty of selecting the proper price index—retail, wholesale, or consumer prices. Since price movements usually differ somewhat, the stabilization of one price index would not mean stabilization of the others.

In rejecting price stability, the Board pointed out that no statistical mechanism alone, no matter how well contrived, could furnish an adequate guide to Federal Reserve credit administration. "In its ultimate analysis, credit administration is not a matter of mechanical rules, but is and must be a matter of judgment—of judgment concerning each specific credit situation at the particular moment of time when it has arisen or is developing." Moreover, in arriving at decisions on credit policy, guidance should be sought not from any single index such as the price level, but from a variety of basic economic data which reflect the general business and credit situation. Statistical information cannot be a substitute for judgment, but it does furnish an indispensable factual basis for credit judgment and for the development of credit policy.

In 1937, the Board expressed its position in a statement to Congress on the objectives of monetary and credit policy. Again the Board rejected a stable price level as the major goal of policy, and stated that it was "in full agreement with the ultimate objective of the proposals to promote economic stability, which means the maintenance of as full employment of labor and of the productive capacity of the country as can be continuously sustained." Thus, Federal Reserve authorities moved toward the broader objective of general economic stability with a variety of business and financial data serving as guides in making decisions as to what action should be taken.

How was the goal to be achieved? The Board recognized that monetary policy alone could not accomplish the goal of maintaining economic stability. The attainment of the objective would require the cooperation of other agencies of the Government also. The Federal Reserve System, however, could make a major contribution through its influence both on the flow of money and on the soundness of banking conditions.

Orderly Market for Government Securities

A new intermediate objective, which later was to become of major significance, emerged in 1937 in connection with open market operations. On April 4, the Federal Open Market Committee announced that "with a view (1) to exerting its influence toward orderly conditions in the money market, and (2) to facilitating the orderly adjustment of member banks to the increased reserve requirements," the Federal Reserve System was prepared to make open market purchases of U. S. Government securities in such amounts and at such times as might be desirable. The goal of attempting to maintain orderly conditions in

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the Government securities market was justified on two grounds. First, the Government bond market had become a much more important segment of the money market, and banks in financial centers particularly were using their Government bond portfolios to adjust their cash position. Second, the increasing importance of bonds as bank investments and the tendency for prices of long-term bonds to fluctuate more widely, made the maintenance of stability in the bond market a matter of concern in banking administration.

The objective of maintaining an orderly market for Government securities was explained more fully in 1939. The purpose was to protect the market from "violent fluctuations of a speculative, or panicky nature" such as that caused by the outbreak of hostilities in Europe. However, it was not to "assure any given level of prices or yields for Government securities" nor to prevent "an orderly rise or fall in United States bond prices in response to changes in underlying credit, as expressed in the interest rate. . . ." Neither was there any intention of trying to preserve any profits member banks might have in Governments, nor to protect them against losses. It was believed that an orderly market in Government securities would help steady the entire capital market and contribute toward further economic recovery. It would also tend to safeguard Government security portfolios which were of growing importance to member banks from "unnecessarily wide and violent fluctuations in price."

Since 1939, maintaining an orderly market for Government securities has been an important intermediate objective of System policy. It was not pursued as an end in itself, but rather as a means of achieving the objectives of economic stability, and during the war of financing the heavy expenditures required. In the post-war period, the System chose to continue to follow the objective of maintaining an orderly market for Government securities despite its inflationary implications in preference to the dangers of a disorderly market.

INTERRELATION OF OBJECTIVES

In pursuing its basic and continuing objective of economic stability at high levels of production and employment, the Federal Reserve System has found it necessary to set up intermediate objectives or guides in formulating programs of action appropriate to specific situations. At first, as we have seen, System objectives were more narrowly conceived and the tendency was to be guided by some "rule of thumb," such as accommodating business at a reasonable cost or limiting credit to productive uses. As experience revealed the scope and complexity of the problems, these mechanical rules were abandoned in favor of judgment based on all available information on credit and general business conditions. Specific objectives and guides were set up in terms of the needs of a given situation—the total quantity of credit in relation to the available supply of goods, an excessive flow of credit into certain uses, maintaining a stable level of prices, or maintaining a stable market for Government securities. A complicating factor, however, is that specific objectives which seem desirable in terms of the ultimate goal of Federal Reserve policy may infringe upon each other or may even be in direct conflict.

The Problem of Conflicting Objectives

Specific objectives may come in conflict either in war or peace. War financing always poses a dilemma. One objective of Federal Reserve policy, of course, must be to assist the Treasury in raising the money needed to finance the war. Another objective is to prevent inflation. If the Treasury could siphon off enough current income through taxation and borrowing from the public to pay the costs of war, the creation of new money could be avoided. However, to the extent these sources of financing are inadequate the remainder must be obtained from the banking system, resulting in an expansion of bank credit and the money supply. If continued, the flow of money payments becomes excessive in relation to the flow of goods and prices tend to rise. Direct controls may be used to hold down prices during the war, but if so the problem of inflation is only postponed to the post-war period when controls are removed. Then the release of pent-up purchasing power and demand makes the avoidance of inflation very difficult, if not impossible.

Both the objectives of furnishing necessary funds to finance the heavy costs of war and of preventing inflation are desirable, but financing the war necessarily takes precedence. Inflation can be prevented only by financing the war out of current income instead of through additions to the money supply. Such a heavy burden on incomes might lower morale and the incentive for production so much as to seriously interfere with the successful prosecution of the war. Thus, the objective of preventing inflation may have to be sacrificed during war periods in the interest of obtaining funds in a way which will foster high morale and a strong incentive toward maximum production.

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The problem of diverging pathways is not limited to wartime. In the late 'twenties, as we have seen, the expanding flow of credit into speculative uses indicated that action should be taken to restrict further credit expansion. On the other hand, existence of unused resources and unemployed labor, and the difficulties of countries trying to return to the gold standard indicated that it should not be restricted.

The recent post-war period provides another illustration of goals which, although desirable in themselves, were in some respects incompatible. Until late 1948, this period was characterized by not only a plethora of money and liquid assets but also a scarcity of goods. The result was a rising spiral of prices, costs, and profits. The basic problem was one of checking inflation without precipitating a depression.

Fundamentally, there were two courses of action the Federal Reserve authorities could have taken. They could have used open market operations and other available instruments to check credit expansion by limiting the supply of bank reserves, leaving the price of Government securities and interest rates free to seek their own level. The primary restraint on inflation would have been exerted by an effective limitation of the money supply. A secondary restraint would have resulted from a rise in interest rates, which might have tended to restrict the private demand for credit especially for uses in which interest was an important part of total cost.

This course of action, however, involved the dangers of a disorderly Government securities market. Sales of Government securities in an unsupported market by lending agencies desiring to shift to loans and other investments would tend to lower the price of securities and raise interest rates. Once security prices began to fall, fear of further declines might start a wave of liquidation of marketable obligations and redemptions of savings bonds. Declining Government security prices would have made more difficult the Treasury's large refunding operations and might have tended to undermine confidence in Government credit at a time when the international situation was tense. The lowering or withdrawal of support prices was not a method by which anti-inflationary pressure could have been applied or released flexibly and gradually as desired. The repercussions of a declining Government securities market might have been difficult to stop before precipitating a severe deflation.

An alternative program was to attempt to limit credit expansion and at the same time maintain a stable market for Government securities. This program provided less freedom of action in checking inflation, but avoided the dangers of a disorderly securities market. Maintaining the price of Government securities made it easy for lending agencies to shift to loans and other investments. Federal Reserve purchases required in supporting the price of Government bonds were a major factor increasing bank reserves and the money supply. Maintaining a stable market for Government securities, therefore, resulted in sacrificing some control over the money supply and the ability of the authorities to check inflation.

The essential problem posed by pursuit of the ultimate goal of economic stability was one of choosing between these alternatives. It was necessary to weigh the advantages of a more effective anti-inflationary action against the dangers of a disorderly Government securities market. The System chose to avoid the latter.

The goal of maximum employment seems likely to pose again the problem of objectives which, although desirable in themselves, are somewhat inconsistent with each other. A decision may have to be made as to whether full employment or preventing inflation shall be the primary objective. The growth of well-organized, powerful groups which are persistently seeking to improve their income position may result in almost constant inflationary pressures. An increase in incomes in response to these pressures tends to raise costs and prices. Under these circumstances, monetary-fiscal policies can be directed toward either permitting the credit expansion and the increase in the money supply required to support the higher income-cost levels, or to restricting credit expansion so as to avoid inflation. If the former, a monetary-fiscal policy directed primarily toward maintaining full employment may become the engine of stair-step inflation. Even extreme inflation is no guarantee of full production, or even of full employment, as the experience of Germany and other countries has demonstrated so well. On the other hand, if monetary-fiscal policy is used primarily to prevent inflation and maintain general economic stability, the result may be some unemployment. How serious this dilemma is will depend primarily upon the willingness of the various groups to limit their income demands to that made possible by rising productivity.

Here again a single guide is inadequate for the most effective determination of policy. A high level of employment and the prevention of inflation are both worthy guides. But the goal of full employment should be pursued only insofar as it is consistent with economic progress and a sustainable level of production, employment, and prices.

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Primary and Secondary Objectives

The complexity of a specific economic situation is such that two or more operating guides will usually appear desirable as means to the ultimate goal of general economic stability. Not all of these can usually be followed without running into conflict. Moreover it is unlikely that each of the intermediate objectives will be of equal importance. Alternative pathways are usually neither black nor white; they are different shades of grey. Low interest rates may help keep down the cost of war financing, but generate inflation; supporting the price of Government bonds during inflation may avoid the dangers of a disorderly market, but interfere with checking the boom. More effective action toward achieving one objective frequently means less success in achieving the other. Under these circumstances, it is necessary to select those intermediate objectives which are most essential in achieving the ultimate goal. These, then, become the primary guides in formulating a program of action, and the others should be pursued only within the limits achievement of the primary objectives makes possible.

The weight to be assigned to specific objectives or guides will vary from time to time. Commodity prices, security prices, the quality of credit, total quantity of credit, the volume of production, the status of employment—any of these may be the key in arriving at policy decisions. Intermediate objectives or guides cannot be arranged into a neat pattern of weights suitable for all circumstances. A wise decision as to the amount of emphasis which should be given to each intermediate objective can be made only with respect to the problems posed by a specific situation.

CONCLUSIONS

An analysis of the guides which have charted the course of Federal Reserve actions during the past thirty-five years reveals the difficulties that have confronted System officials in carrying out the purposes of the Federal Reserve Act. In the nature of the case, the Act itself could furnish little guidance in setting up intermediate objectives, which would lead to the ultimate goal of general economic stability. Hence, the establishment of operating guides which would lead to an effective credit and monetary policy has been given careful consideration from the beginning of the System. Years of experience and careful study have left the System much better equipped to tackle the complex problems of today.

Some of the important lessons of experience with respect to the objectives of Federal Reserve policy may be summarized briefly:

First, the basic, continuing objective of Federal Reserve policy has been general business stability. Intermediate objectives, however, have varied from time to time both as a result of experience and of changing conditions.

Second, it is much easier to establish the correct guides for determining effective credit policy in theory than in actual practice. The pathways which look so black or so white when viewed from the outside become merely different shades of grey to those who through experience are more fully aware of the administrative problems involved and the responsibilities which are being assumed.

Third, in formulating a program of action, mechanical rules cannot serve as a substitute for judgment. For several years, System officials sought rules or automatic guides to follow, but they could not find any which were appropriate for all circumstances. Operating guides must be chosen in terms of the problem posed by a specific situation and not on the basis of some mechanical rule-of-thumb.

Fourth, the problems confronting Federal Reserve authorities are so complex that intermediate objectives, although desirable in themselves, frequently result in actions which may tend to counteract each other. In the case of conflicting objectives, a decision must be made as to which ones are primary and which are secondary. Such a decision can be made only with respect to the conditions existing at a particular time.

Fifth, experience furnishes ample evidence that the establishment of specific objectives by statute would be unwise. It has been fortunate that the Federal Reserve Act stated the objectives of policy only in very broad and general terms. Setting up a list of specific legal objectives for the guidance of Federal Reserve policy would almost certainly handicap the effectiveness of the System and lead to undesirable results. The selection of operating objectives which would be appropriate under all conditions which may arise implies a foresight that no one has yet achieved.

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THE MONTH'S STATISTICS

The industrial recovery occasioned by the resumption, in November 1949, of operations in the coal and steel industries leveled off in January. Employment, income, and production showed little or no change from the previous month.

Although physical output of factory goods, factory employment, and pay rolls remained steady from December to January, they were considerably below a year ago. The number of production workers employed in manufacturing industries of Pennsylvania was 10 per cent below that of the previous January, reflecting primarily a decrease in durable goods factory employment. In the major durable categories, nonelectrical machinery, non-ferrous metals, and transportation equipment showed the greatest declines. While employment income and production in the nondurable goods industries fell below the previous month, their position in year-ago comparisons was much better than durables. Construction contract awards were about the same as in the preceding month, and they continued to be well above those of the corresponding month a year ago. Sustained operations in all major building categories were responsible for the high level of construction activity.

Department store sales and stocks, which rose in November and December dipped in January and were below those of a year ago. Owing largely to unseasonably warm weather, sales of women's and misses' apparel were especially weak, showing a decline of 14 per cent from the dollar volume of January 1949. However, a bright spot in the sales picture appeared in the form of increased sales of housefurnishings. In comparing weekly February sales with those of a year ago, some allowance must be made for the transportation strike in Philadelphia which affected eight shopping days last year.

In leading cities of the Third District, bank deposits and investments declined in February but were above a year ago. On the other hand, business loans increased during the month. They remained, however, about 10 per cent below last year.

SUMMARY	Third Federal Reserve District		United States	
	Per cent change		Per cent change	
	January 1950 from		January 1950 from	
	mo. ago	year ago	mo. ago	year ago
OUTPUT				
Manufacturing production	− 1*	−11*	+ 1	− 3
Construction contracts	+ 1	+15	− 8	+39
Coal mining	+ 1	−28	− 4	−32
EMPLOYMENT AND INCOME				
Factory employment	− 1*	−10*	0	− 6
Factory wage income	0*	− 9*	....	....
TRADE**				
Department store sales	− 3	− 6	− 4	− 4
Department store stocks	− 4	− 7	0	− 3
BANKING (All member banks)				
Deposits	− 1	+ 3	0	+ 3
Loans	− 1	+ 3	− 1	0
Investments	+ 1	+ 8	+ 1	+11
U. S. Govt. securities	+ 1	+ 7	+ 1	+10
Other	+ 1	+13	+ 1	+16
PRICES				
Wholesale	....	....	0	− 6
Consumers	− 1†	− 3†	0	− 2
OTHER				
Check payments	−10	+ 9	−10	+ 1
Output of electricity	− 1	− 2	....	....

*Pennsylvania. **Adjusted for seasonal variation. †Philadelphia.

LOCAL CONDITIONS	Factory*				Department Store				Check Payments	
	Employment		Payrolls		Sales		Stocks			
	Per cent change Jan. 1950 from		Per cent change Jan. 1950 from		Per cent change Jan. 1950 from		Per cent change Jan. 1950 from		Per cent change Jan. 1950 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Allentown	− 1	− 8	0	− 7	.....	.....	.....	.....	− 8	0
Altoona	+35	−12	+26	−23	.....	.....	.....	.....	− 7	− 4
Harrisburg	+ 1	− 5	+ 6	−10	.....	.....	.....	.....	− 9	+ 2
Johnstown	− 6	−15	− 5	−20	.....	.....	.....	.....	− 9	− 9
Lancaster	− 1	− 9	− 3	−12	−58	− 7	+ 3	− 5	+ 1	+16
Philadelphia	− 1	−11	− 1	− 8	−56	− 5	− 7	− 8	− 9	+11
Reading	0	− 8	− 2	− 9	−61	−13	− 5	− 8	−16	+ 4
Scranton	0	0	0	+ 8	.....	.....	.....	.....	−10	+ 3
Trenton	....	....	....	....	−62	− 5	−14	−14	− 6	+10
Wilkes-Barre	− 3	−14	− 2	−13	−62	−14	− 2	− 4	−15	−23
Williamsport	+ 2	− 4	+ 1	− 2	.....	.....	.....	.....	−13	+ 1
Wilmington	+ 2	− 6	+ 7	− 6	.....	.....	.....	.....	−20	+ 9
York	+ 5	+ 2	+ 5	+ 2	−60	− 7	− 1	− 4	− 2	− 4

*Not restricted to corporate limits of cities but covers areas of one or more counties.

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MEASURES OF OUTPUT

	Per cent change January 1950 from	
	month ago	year ago
MANUFACTURING (Pa.)*	− 1	−11
Durable goods industries	0	−16
Nondurable goods industries	− 1	− 3
Foods	− 2	− 0
Tobacco	+ 4	−16
Textiles	− 2	− 3
Apparel	0	+11
Lumber	− 3	−11
Furniture and lumber products	0	+ 6
Paper	− 3	− 3
Printing and publishing	− 3	0
Chemicals	+ 1	−12
Petroleum and coal products	+ 1	− 1
Rubber	− 4	− 1
Leather	− 1	− 1
Stone, clay and glass	− 1	−12
Iron and steel	+ 2	−13
Nonferrous metals	− 5	−30
Machinery (excl. electrical)	− 1	−27
Electrical machinery	+ 2	− 8
Transportation equipment (excl. auto)	− 9	−37
Automobiles and equipment	+ 7	+ 5
Other manufacturing	− 2	−13
COAL MINING (3rd F. R. Dist.)†	+ 1	−28
Anthracite	+10	−22
Bituminous	−33	−59
CRUDE OIL (3rd F. R. Dist.)††	+ 2	−10
CONSTRUCTION — CONTRACT AWARDS (3rd F. R. Dist.)**	+ 1	+15
Residential	+ 3	+ 9
Nonresidential	− 5	+26
Public works and utilities	+ 7	+13

*Temporary series—not comparable with former production indexes.
**Source: F. W. Dodge Corporation. Changes computed from 3-month moving averages, centered on 3rd month.
†U.S. Bureau of Mines. ††American Petroleum Inst. Bradford field.

EMPLOYMENT AND INCOME

Pennsylvania Manufacturing Industries* Indexes (1939 avg. = 100)	Employment			Payrolls			Average Weekly Earnings		Average Hourly Earnings	
	Jan. 1950 (Index)	Per cent change from mo. ago	Per cent change from year ago	Jan. 1950 (Index)	Per cent change from mo. ago	Per cent change from year ago	Jan. 1950	% chg. from year ago	Jan. 1950	% chg. from year ago
All manufacturing	113	−1	−10	268	0	− 9	$53.36	+ 1	$1.356	0
Durable goods industries	130	0	−15	297	+ 1	−15	59.27	+ 1	1.489	+1
Nondurable goods industries	97	−1	− 3	234	− 1	0	46.33	+ 4	1.194	+1
Foods	120	−2	− 2	251	− 1	+ 2	46.86	+ 4	1.143	+2
Tobacco	83	+2	−15	188	+ 4	−15	29.95	+ 1	.789	+1
Textiles	77	−1	− 5	197	− 3	− 3	45.85	+ 2	1.197	0
Apparel	88	−1	+ 5	232	+ 2	+13	37.12	+ 7	.959	+1
Lumber	86	−2	− 6	190	− 3	−11	41.23	− 6	1.096	0
Furniture and lumber products	96	+2	+ 4	238	+ 1	+ 7	46.09	+ 3	1.057	+1
Paper	117	−1	0	271	− 4	+ 3	50.00	+ 4	1.214	+5
Printing and publishing	130	−1	− 1	282	− 3	+ 4	61.29	+ 6	1.657	+5
Chemicals	109	+2	−12	243	+ 1	− 9	52.85	+ 3	1.320	+3
Petroleum and coal products	149	0	− 1	326	+ 2	+ 1	66.36	+ 2	1.665	+2
Rubber	119	−3	− 8	241	− 2	− 1	50.44	+ 8	1.419	0
Leather	87	0	0	189	0	+ 3	37.19	+ 3	1.042	+1
Stone, clay and glass	112	−2	−12	259	− 1	−12	52.74	+ 1	1.285	+1
Iron and Steel	122	0	−13	280	+ 2	−13	62.07	+ 1	1.562	+2
Nonferrous metals	102	−3	−26	218	− 4	−30	55.47	− 5	1.433	−1
Machinery (excl. electrical)	160	0	−22	340	− 2	−24	53.94	− 3	1.426	+2
Electrical machinery	208	+1	− 9	464	+ 2	− 8	62.26	+ 2	1.545	+1
Transportation equipment (excl. auto)	152	−9	−37	318	− 8	−36	64.04	+ 1	1.589	−1
Automobiles and equipment	123	+4	− 1	297	+10	+14	66.16	+15	1.600	+9
Other manufacturing	118	−2	−11	243	0	− 9	43.35	+ 1	1.178	+2

*Production workers only.

TRADE

Third F. R. District Indexes: 1935–39 Avg. = 100 Adjusted for seasonal variation	Jan. 1950 (Index)	Per cent change Jan. 1950 from month ago	Per cent change Jan. 1950 from year ago
SALES			
Department stores	267	− 3	− 6
Women's apparel stores	229	0	−11
Furniture stores	...	−51*	− 3*
STOCKS			
Department stores	224p	− 4	− 7
Women's apparel stores	228	+ 7	+ 3
Furniture stores	...	+ 3*	− 5*

Recent Changes in Department Store Sales in Central Philadelphia	Per cent change from year ago
Week ended Feb. 4	− 2
Week ended Feb. 11	+ 9#
Week ended Feb. 18	+82#
Week ended Feb. 25	−13

*Not adjusted for seasonal variation. p—Preliminary.
#In 1949 there was a transportation strike in Philadelphia which affected two trading days in the week ended February 12, and six trading days in the week ended February 19.

Departmental Sales and Stocks of Independent Department Stores Third F. R. District	Sales % chg. January 1950 from year ago	Stocks (end of month) % chg. January 1950 from year ago	Ratio to sales (months' supply) January 1950	Ratio to sales (months' supply) January 1949
Total—All departments	− 7	− 4	3.0	2.9
Main store total	− 5	− 3	3.3	3.2
Piece goods and household textiles	− 7	+ 5	2.3	2.0
Small wares	− 1	+ 3	3.5	3.3
Women's and misses' accessories	− 6	+ 4	3.5	3.2
Women's and misses' apparel	−14	− 1	2.3	2.0
Men's and boys' wear	− 7	+ 5	4.1	3.6
Housefurnishings	+ 2	−13	3.8	4.5
Other main store	−10	−12	4.2	4.3
Basement store total	−15	− 6	2.1	2.0
Domestics and blankets	− 5	− 1	1.8	1.7
Small wares	+ 1	+ 2	2.4	2.3
Women's and misses' wear	−19	− 3	1.7	1.4
Men's and boys' wear	−11	− 4	2.6	2.4
Housefurnishings	−11	−20	3.0	3.3
Shoes	−16	− 5	2.9	2.6
Nonmerchandise total	− 6	.....	.....	.....

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CONSUMER CREDIT

Sale Credit — Third F. R. District	Sales: % chg. January 1950 from year ago	Receivables (end of month): % chg. January 1950 from year ago
Department stores		
Cash	−14	.....
Charge account	− 4	+ 2
Instalment account	+15	+18
Furniture stores		
Cash	−16	.....
Charge account	− 1	.....
Instalment account	+ 3	+11

Loan Credit — Third F. R. District	Loans Made: % chg. January 1950 from year ago	Loan balances outstanding (end of month): % chg. January 1950 from year ago
Consumer instalment loans		
Commercial banks	+53	+16
Industrial banks and loan companies	− 5	0
Small loan companies	−33	+13
Credit unions	+47	+24

PRICES

Index: 1935-39 average = 100	Jan. 1950 (Index)	Per cent change from month ago	Per cent change from year ago
Wholesale prices—United States	188	0	− 6
Farm products	204	0	−10
Foods	196	−1	− 7
Other	180	0	− 5
Consumer prices			
United States	167	0	− 2
Philadelphia	166	−1	− 3
Food	191	−1	− 5
Clothing	182	−1	− 4
Rent	122	0	.....
Fuel	144	−1	0
Housefurnishings	189	−1	− 4
Other	152	0	0

Weekly Wholesale Prices—U.S. (Index: 1935-39 average = 100)	All commodities	Farm products	Foods	Other
Week ended Feb. 7	188	207	197	179
Week ended Feb. 14	189	209	198	179
Week ended Feb. 21	189	209	200	179
Week ended Feb. 28	189	210	200	179

Source: U.S. Bureau of Labor Statistics.

BANKING

MONEY SUPPLY AND RELATED ITEMS — United States (Billions $)	Jan. 25, 1950	Changes in— four weeks	Changes in— year
Money supply, privately owned	170.0	0	+1.9
Demand deposits, adjusted	86.8	+ .2	+1.5
Time deposits	58.7	+ .3	+1.1
Currency outside banks	24.5	− .5	− .6
Turnover of demand deposits	18.9*	−5.5*	−2.1*
Commercial bank earning assets	121.6	+ .8	+7.1
Loans	43.1	− .2	+ .6
U.S. Government securities	68.1	+ .9	+5.2
Other securities	10.4	+ .1	+1.3
Member bank reserves held	16.4	+ .1	−3.6
Required reserves (estimated)	15.6	+ .1	−3.5
Excess reserves (estimated)	.8	0	− .1

Changes in reserves during 4 weeks ended January 25, reflected the following:

	Effect on reserves
Decrease in Reserve Bank holdings of Governments	−1.0
Decrease of currency in circulation	+ .8
Net payments by the Treasury	+ .4
Other transactions	− .1
Change in reserves	+ .1

*Annual rate for the month and per cent changes from month and year ago at leading cities outside N. Y. City.

OTHER BANKING DATA	Feb. 22, 1950	Changes in— four weeks	Changes in— year
Weekly reporting banks—leading cities United States (*billions* $):			
Loans—			
Commercial, industrial and agricultural	13.9	0	− 1.4
Security	2.0	0	+ .2
Real estate	4.4	0	+ .3
To banks	.3	0	+ .1
All other	4.4	0	+ .6
Total loans—gross	25.0	0	− .2
Investments	42.4	− .9	+ 5.3
Deposits	75.4	−1.2	+ 2.5
Third Federal Reserve District (*millions* $):			
Loans—			
Commercial, industrial and agricultural	484	+ 12	− 50
Security	37	+ 5	+ 10
Real estate	107	0	+ 14
To banks	10	+ 3	+ 3
All other	320	+ 5	+ 45
Total loans—gross	958	+ 25	+ 22
Investments	1821	− 36	+ 205
Deposits	3060	− 35	+ 156
Member bank reserves and related items United States (*billions* $):			
Member bank reserves held	16.2	− .2	− 3.3
Reserve Bank holdings of Governments	17.6	− .1	− 4.7
Gold stock	24.3	− .1	+ .1
Money in circulation	27.0	+ .1	− .5
Treasury deposits at Reserve Banks	.4	− .2	− 1.2
Federal Reserve Bank of Phila. (*millions* $)			
Loans and securities	1180	− 9	− 372
Federal Reserve notes	1604	+ 8	− 32
Member bank reserve deposits	743	− 26	− 154
Gold certificate reserves	1297	+ 19	+ 99
Reserve ratio (%)	52.9%	+1.2%	+ 9.0%

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