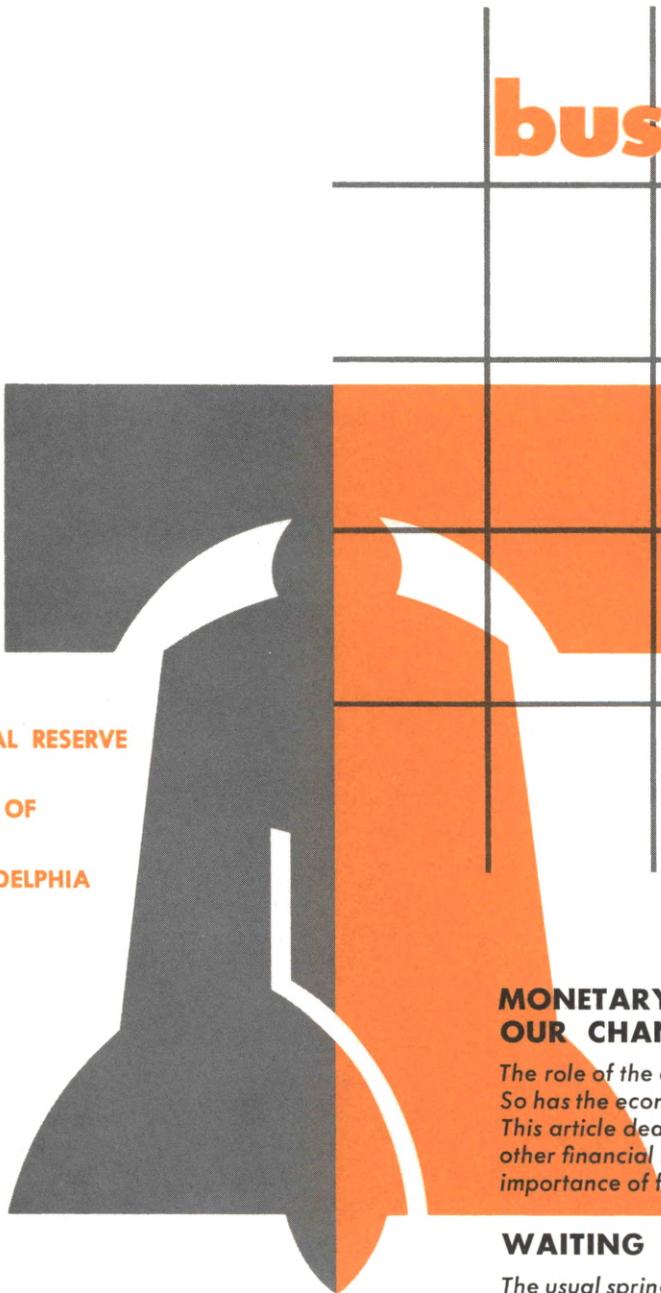


business review



FEDERAL RESERVE
BANK OF
PHILADELPHIA

MONETARY POLICY: OUR CHANGING ECONOMIC ENVIRONMENT

The role of the central bank has changed in the past few decades. So has the economic environment in which it operates. This article deals with significant changes in commercial banking, other financial institutions, the money market, and the importance of federal finances.

WAITING FOR SPRING

The usual spring pick-up in automobile sales is late this year. We talked to about 40 district dealers during the last week in March and this article summarizes the situation as they saw it.

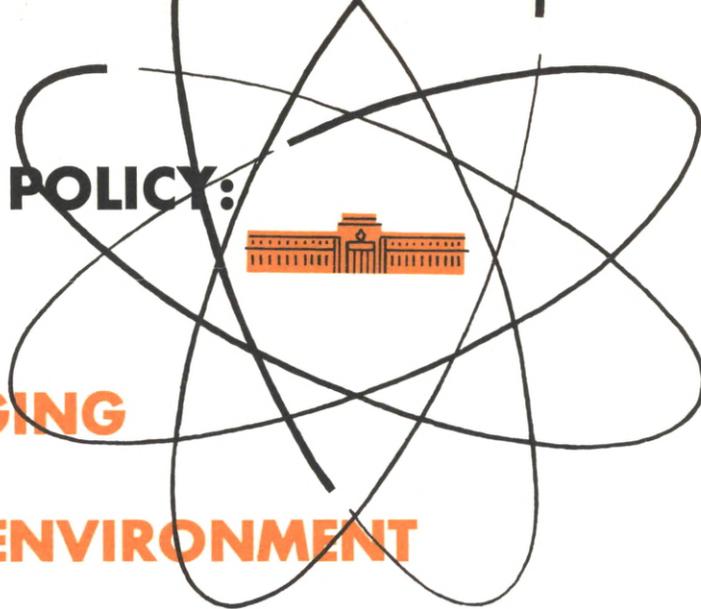
CURRENT TRENDS

Housing has been sensitive to changes in money policy.

MONETARY POLICY:

OUR CHANGING

ECONOMIC ENVIRONMENT



Monetary policy—Federal Reserve actions to influence the supply, availability, and cost of credit—seems to be a subject of growing public interest. One aspect frequently mentioned recently is the import for monetary policy of basic economic changes during the past few decades. It may be helpful, therefore, to review briefly the changing role of central banking and the changing environment in which it has operated. No attempt will be made in this article to cover all significant economic changes of the past few decades; instead, it deals only with those changes of more significance for the operation of monetary policy. Although the analysis deals primarily with conditions in the United States, it has, in many respects, a broader application.

Before going into economic changes of the past few decades, let us take a brief look at changes in our concept of what a central bank should do.

EXPANDING ROLE OF CENTRAL BANKING

Central banking has a fairly long history. Banks performing some of the functions of a central bank existed in most of the countries of Europe for many years prior to this century. Growing rec-

ognition of the need for some institution to regulate credit and the money supply in the interest of economic stability led to the establishment of central banks in many countries in the first half of the present century. The Federal Reserve System was created in 1913, and since World War I approximately 50 countries have established central banks. In addition to the growth in numbers, central banks were given added responsibilities as countries attempted to develop programs and policies to iron out the upward and downward swings in business activity and employment.

Viewed broadly, the evolution of the concept of what a central bank should do may be classified into three stages: preserving the gold standard, preventing excessive credit expansion and booms, and positive and continuous action to help maintain stability and growth.

Protecting the gold standard

For a considerable period prior to the Great Depression, most of the leading countries of the world were on a gold standard except during and immediately following World War I. It was thought that by maintaining the gold standard,

over-issue of the currency and excessive expansion of credit would be prevented. The responsibilities of the central bank were viewed as being rather limited. Its principal task, within the limits imposed by the gold standard, was to regulate credit in such a way as to minimize fluctuations in foreign receipts and payments, and thereby protect the gold reserve.

The chief instrument of central-bank policy was the discount rate. An increase in the rate, by discouraging credit expansion and encouraging an increase in foreign receipts relative to payments, tended to induce an inflow of gold or check an outflow. A reduction in the discount rate had the opposite effects. Economic instability within the country was of little concern in determining central-bank credit policy.

Toward internal stability

In its early years, the Federal Reserve's responsibilities were viewed rather narrowly. The country's external position had less influence in shaping Federal Reserve policy perhaps than was the case in a number of foreign central banks. At times, System actions were directed toward protecting the gold reserve. Official statements revealed more concern with objectives such as accommodating commerce and business at reasonable rates, safeguarding the quality of credit, and preventing an excessive use of credit for speculative and other nonproductive purposes. The problem of internal economic stability was viewed mainly as one of preventing excessive expansion—of avoiding or checking a boom. By so doing, it was thought that a subsequent depression could be avoided. Depression policy usually consisted of relaxing restraints imposed during the preceding boom. It did not include vigorous action to cushion the decline and promote recovery.

Federal Reserve policy prior to the depression,

although concerned mainly with internal economic conditions, was more passive than in recent years. There was more emphasis on “policing” conditions believed to be inimical to enduring stability such as checking booms, preserving the quality of bank credit, and preventing the use of credit for speculative purposes. The concept of the job of the central bank did not yet encompass continuous efforts to adjust the flow of credit and money to the flow of goods and services in such a way as to help maintain over-all economic stability.

Stability and growth

The severe and prolonged depression of the thirties focused attention on the problem of unemployment. It dispelled the formerly widely held view that loss of a job was primarily one of personal responsibility; instead, unemployment came to be regarded as resulting largely from the defective operation of our economic system. Hence, the problem of unemployment and unused resources could not be solved by uncoordinated individual actions—only by centralized and coordinated policies directed toward removing the causes of fluctuations in the volume of production and employment.

One result of this shift in opinion was that government began to accept increasing responsibility for maintaining conditions which would promote full employment. World War II diverted attention to problems of defense, but the end of the war revived fears of large-scale unemployment. The Employment Act of 1946 committed the Federal Government, in cooperation with state and local governments and private industry, to coordinate its activities toward the objective of promoting “maximum employment, production, and purchasing power.”

Primary reliance for achieving the goals of the

Employment Act has been placed on monetary, fiscal, and debt-management policies. Monetary policy thus became one of the primary tools—not merely for preventing booms, but for maintaining stability at high levels of production, employment, and income. This ultimate objective was soon modified to include growth. Stability is not enough. We want a growing economy, too.

Thus in the almost universal quest for internal economic stability the Federal Reserve, as most central banks, has emerged with a sizable and complicated task. It has the responsibility of using its powers over credit and the money supply to adjust total spending in such a way as to help achieve the multiple objective of: keeping the price level stable, maintaining “full employment” of labor and resources, and promoting economic growth.

CHANGING ECONOMIC ENVIRONMENT

Concepts of the role of the central bank reflect, in large part, the economic environment in which it operates. Changes in the economy may also affect the ability of the central bank to achieve its objectives. We turn now to some of the more significant economic changes of the past few decades, particularly in our financial structure.

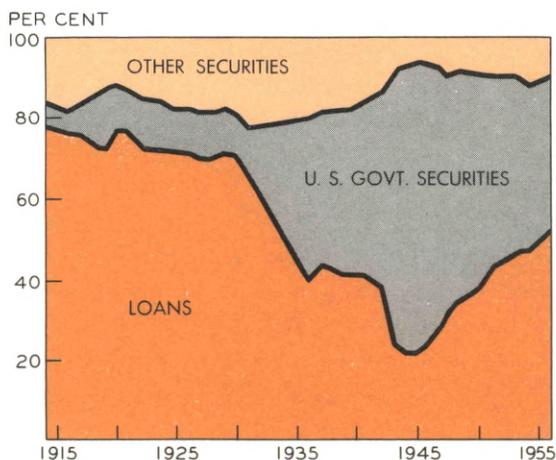
Commercial banking

Commercial banks provide the bulk of our money supply in the form of checking accounts—check-book money. It is primarily by altering the lending and investing capacity of commercial banks that Federal Reserve actions affect the money supply, which in turn influences the total spending of consumers, business firms, and others. Thus the credit activities of commercial banks—the primary source of deposit money—play an important role both in determining and in transmitting the impact of monetary policy on spending.

Commercial banking has undergone some far-reaching changes in the past few decades: in the structure of its earning assets, and the composition of the loan portfolio.

Shift in earning assets. Prior to the Great Depression, approximately three-fourths of the earning assets of commercial banks were in loans. In 1914, for example, investments totaled nearly \$4 billion as compared to over \$13 billion in loans.

DISTRIBUTION OF EARNING ASSETS
ALL COMMERCIAL BANKS 1914-1956



Moreover, holdings of non-Government securities were much larger than U. S. Government issues.

Two significant shifts emerged from the depression of the thirties. Loans began a downward trend, both in total amount and relative to investments. Depression and then stagnation brought a sharp drop in the private demand for bank credit. Private demand continued at a low level during World War II as manpower and resources were shifted to war and defense production.

Investments in contrast to loans rose during most of the thirties and during the war period. The gold inflow of the thirties and the weak demand for credit built up large excess reserves. Banks

were seeking an outlet for excess funds, especially liquid, short-term investments. Deficit financing by the Federal Government during the depression and World War II brought a sharp rise in Treasury securities outstanding. This combination of factors—ample reserves, a weak demand for loans, and an increasing supply of Treasury issues—resulted in a large increase in bank holdings of Government securities.

By the end of the war, the relative position of bank loans and investments had just about been reversed. About three-fourths of earning assets were in investments, mostly U. S. Governments, and less than one-fourth was in loans. The post-war rise in business activity brought a sharp increase in the demand for bank credit, and loans rose substantially. To obtain some of the funds needed for loans, banks reduced their holdings of securities, especially Treasury obligations. Commercial banks still hold nearly \$60 billion of Government securities, however, and investments are considerably more important than they were in the twenties.

New types of loans. A commercial bank in extending credit creates a deposit and acquires an asset. A breakdown of the loan portfolio shows the types of economic activity being supplied with bank credit.

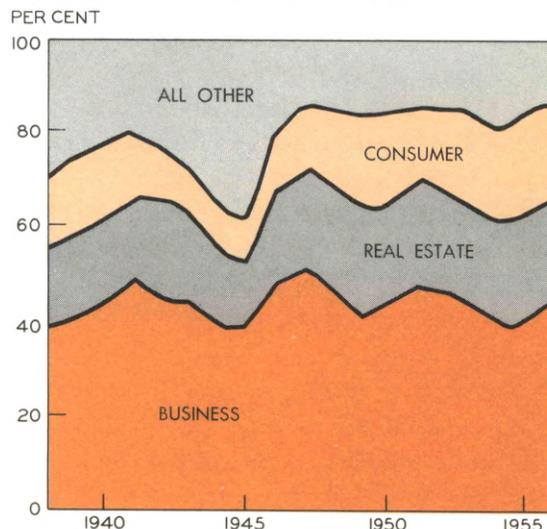
Available data indicate that in the early part of the century, bank loans consisted mostly of short-term credits to business firms, especially for financing the trading and storage of commodities, and loans against marketable securities. The loan portfolio reflected the accepted principle of the time that commercial banks, with liabilities payable on demand or short notice, should make only short-term, self-liquidating commercial loans. Loans against securities, although technically in-

consistent with this theory, were regarded as liquid and readily convertible into cash.

In 1920, about 30 per cent of bank loans were against securities, the remainder being mostly commercial loans. The stock-market boom of the late twenties siphoned more bank credit into the market, and in 1929 nearly one-half of bank loans was on securities. The early concept of appropriate types of loans confined bank credit to narrow segments of the economy.

The situation banks found themselves in during the depression nudged them into new types of loans as well as investments. Many commercial banks began moving into the consumer-credit field, making loans for the purchase of automobiles and other consumer durables. FHA insurance and adoption of the amortization principle made home mortgages more suitable for banks. They began adding increasing amounts of these loans to their portfolios. Technological progress created a growing demand for intermediate and longer-term credit for the purchase of machinery and other equipment. To meet this need and to

MEMBER BANK LOANS—U. S. PERCENTAGE DISTRIBUTION 1938-1956



compete more effectively with savings institutions, banks began making term loans to business. Term loans—usually repayable in instalments in from one to five years—were better suited to the longer-term credit needs of modern industry. These newer types of loans, which emerged in the thirties, expanded rapidly in the post-war period.

In 1938 a revision of the data reported by member banks provided for a more detailed breakdown of loans. At the end of that year, consumer loans were 14 per cent and non-farm home loans 18 per cent of total member-bank loans. Although not reported separately, independent surveys revealed that term loans to business had also increased substantially. Home mortgage, consumer, and term loans now account for over one-half of member-bank loan portfolios.

Another significant change in commercial banking is in methods employed in adjusting their reserve positions; however, this will be considered in a later section dealing with changes in the money market.

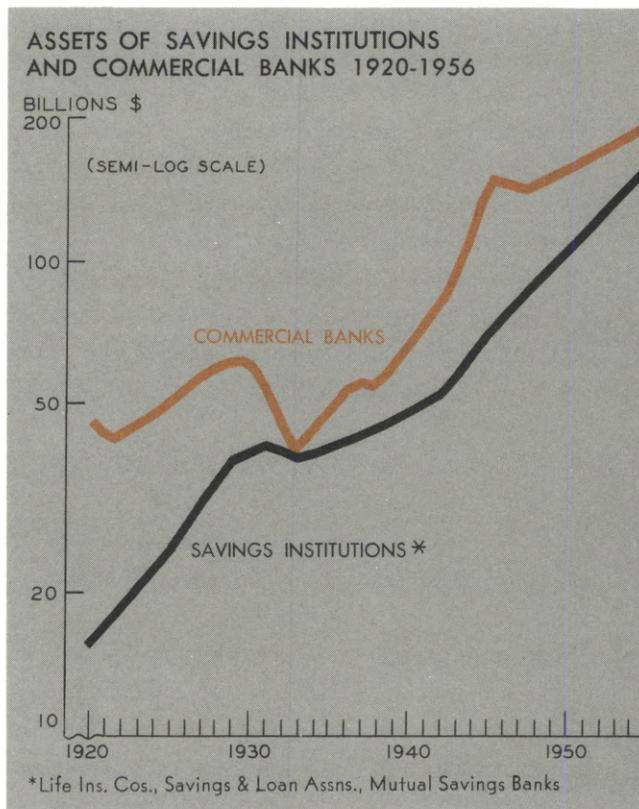
Growth of other financial institutions

Another significant development of the past few decades is the growth of non-bank financial institutions. We shall consider briefly only three of the more important groups: savings institutions such as life insurance companies, savings banks, savings and loan associations, and pension and retirement funds; institutions lending to consumers such as sales finance companies, consumer finance companies, and credit unions; and federal credit agencies, most of them established in the thirties to help alleviate the credit crisis which then existed.

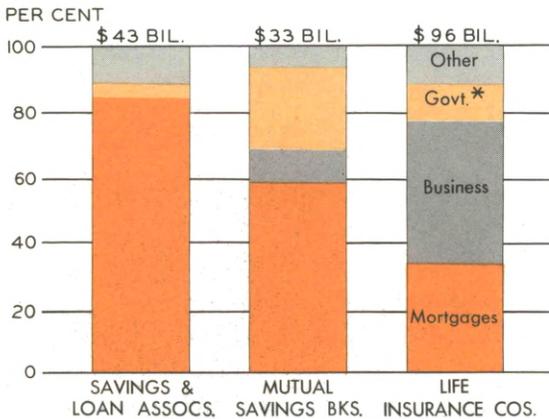
Savings institutions. These institutions are primarily financial intermediaries. They mobilize the savings of millions of people and make them available to borrowers either by direct loans or by pur-

chasing securities. The same is true with respect to the time deposits of commercial banks. Savings institutions differ from commercial banks, however, in two important respects: they cannot create new money, and the total amount of credit they can extend is limited by their net inflow of savings instead of the availability of reserves to support newly created deposits. For our purposes, it is the growth of these institutions and how they employ their funds that are important.

In 1920, the combined assets of life insurance companies, savings banks, and savings and loan associations were \$15.6 billion—only one-third of the assets of all commercial banks. Data on pension and retirement fund assets for that date are



DISTRIBUTION OF ASSETS OF SAVINGS INSTITUTIONS DECEMBER 31, 1956



*Government consists primarily of U.S. Treasury obligations

not available; however, they were quite small because the establishment of such funds did not get under way on a large scale until later.

The resources of these savings institutions have increased substantially since 1920. They continued to grow during most of the depression period, although at a slower rate. In the early thirties the sharp decline in commercial-bank loans brought bank assets down almost to the combined total of the savings institutions.

The rise in the assets of both banks and savings institutions in the post-war period has been rapid. At the end of last year, total resources of the savings institutions were four-fifths of the total assets of commercial banks. In addition, the assets of non-insured, corporate pension funds and state and local government retirement funds totaled \$24 billion in 1955.

Savings institutions, with less need for liquidity than commercial banks, employ more of their funds in longer-term loans and investments. Their direct loans overlap those of commercial banks

mainly in home mortgages and longer-term loans to business.

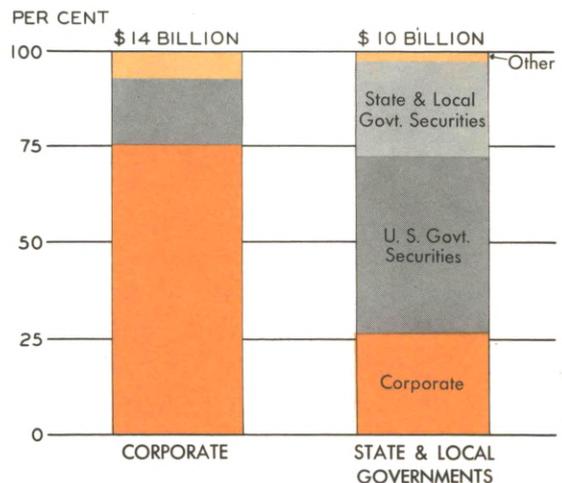
The biggest block of life-insurance assets is in business securities, primarily bonds. This represents mainly long-term credit extended to corporations for the acquisition of fixed assets. Mortgages, chiefly on homes, are their next largest asset. Life insurance companies also hold a sizable amount of Government securities, mostly the longer-term issues.

Mutual savings banks are principally mortgage lenders. About three-fifths of their assets are in mortgages, mostly on residential properties. About one-fourth of their assets is in Government securities, and 15 per cent are in other securities, mostly corporate bonds.

Savings and loan associations are predominantly mortgage lenders. At the end of last year, 84 per cent of their assets were in mortgages—mostly to home owners.

Non-insured, corporate pension funds are invested mainly in corporate securities. On the other

DISTRIBUTION OF ASSETS OF PENSION FUNDS—1955



hand, the bulk of state and local government retirement funds is put into U. S. and state and local government securities. Social security funds managed by the Treasury are invested in U. S. Government securities, mostly special issues.

Institutional savings, including pension and retirement funds, have become an increasingly important source of credit during the past few decades. Most of their funds, however, goes into real-estate mortgages, to corporations, to the Federal Government, and to state and local governments. Such funds are also primarily a source of long-term rather than short-term credit.

Consumer lenders. Sales finance companies, one of the first in the instalment credit field, have become an important source of consumer credit for the purchase of automobiles and other durable goods. Last year, they accounted for 24 per cent of all consumer instalment credit extended. At the end of 1956, sales finance companies held 29 per cent of such credit outstanding, four-fifths of their holdings consisting of automobile paper.

Other financial institutions such as consumer finance companies and credit unions also extend consumer credit. These institutions have grown over the years, but each of these types of institutions is a much less important source of consumer credit than either commercial banks or sales finance companies. Collectively, however, they accounted for 24 per cent of instalment loans to consumers last year, and at the end of the year held 20 per cent of consumer instalment credit outstanding.

Most of these non-bank consumer lenders differ from savings institutions in that a substantial part of their lendable funds is derived, either directly or indirectly, from commercial banks. To the extent that funds are derived from commercial banks, newly created deposits instead of savings are transferred to consumer borrowers. Credit

unions get practically all of their funds from the savings of members, but they are a small factor in total consumer lending.

Federal credit agencies. Numerous federal credit agencies were established in the thirties, most of them for the purpose of alleviating the credit crisis of that period. Many of these institutions, however, are still in existence. Their influence is most important in housing and agricultural credit.

These agencies are similar to other non-bank lenders in that they cannot directly create deposits and expand the money supply. The volume of their direct loans is quite small but their influence on credit terms extended by private lenders is more significant.

Direct loans made by federal credit agencies account for only a very small fraction of total credit extended except in the field of agriculture. Outstanding loans of Government credit agencies to aid agriculture are roughly one-third of total agricultural loans. The largest amount of loans is by the Rural Electrification Administration. The next largest is the Commodity Credit Corporation, which makes loans against commodities as part of the Government's program of supporting the prices of selected farm products. The volume of CCC loans tends to rise when the prices of farm commodities are weak and decline when farm prices rise above the support level.

Federal credit agencies derive their funds primarily from two sources: from the sale of securities in the market and from the Treasury. The sale of their own securities, either directly or indirectly, to commercial banks tends to add to deposits and expand the money supply. Sales to non-bank investors may tap idle balances, and to that extent increase total spending. The results are similar in the case of funds obtained from the Treasury if the latter is forced to borrow by selling

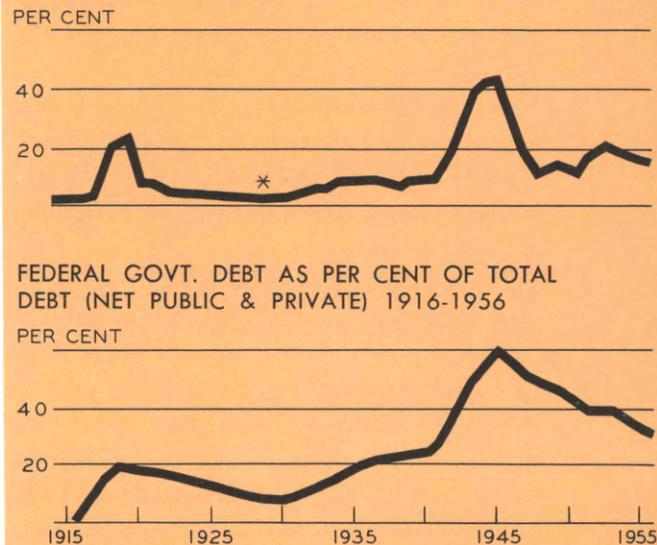
securities. In view of the small amount of direct loans being made by Government credit agencies, however, the impact of obtaining the necessary funds is relatively minor.

The principal influence of federal credit agencies is on the policies of private lenders. More liberal terms on home mortgages—for example, smaller down payments, lower interest rates, and longer maturities—have tended to expand the demand for housing credit. People unable or unwilling to meet more rigid terms are induced to borrow. On the other hand, Government guarantees and insurance increase the availability of credit for selected purposes. Private lenders protected against losses are induced to make credit available on easier terms and to less creditworthy borrowers than they would be willing to do otherwise.

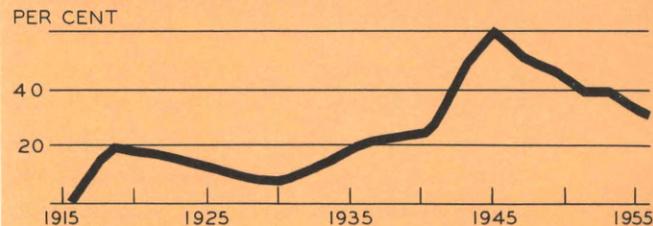
The bulk of Government guaranteed and insured loans has been made in the field of housing. Such protection, together with popularization of the amortized loan, have made home mortgages more acceptable to both borrowers and lenders. Forty-four per cent of all home loans outstanding are insured or guaranteed by the Federal Housing and Veterans Administrations. Government insurance and guarantees are of minor importance, however, in other types of lending.

Federal credit agencies may affect also the distribution of the available supply of credit among borrowers. Insurance and guarantees do not increase the total supply of credit; however, they do tend to increase the amount made available for the types of loans that are guaranteed or insured. Fixed maximum rates—e.g., FHA and VA mortgages—tend to divert a larger part of available credit in periods of tight money into conventional mortgages and other loans affording a higher rate of return.

FEDERAL GOVT. EXPENDITURES AS PER CENT OF GNP 1914-1956



FEDERAL GOVT. DEBT AS PER CENT OF TOTAL DEBT (NET PUBLIC & PRIVATE) 1916-1956



*Revised GNP Series

Fiscal and debt-management policies

In 1916, Federal Government expenditures were \$700 million or 1.5 per cent of gross national expenditure (G.N.P.). The federal debt amounted to \$1.2 billion, only 1.5 per cent of all public and private debt outstanding. The financial operations of the Federal Government were thus a relatively unimportant force in shaping the course of economic activity.

Two world wars and a severe depression brought drastic changes. World War I pushed federal expenditures to a peak of \$18.5 billion for the year ending June 30, 1919—about 26 times the pre-war level. As always in a major war, the federal debt jumped also—to a peak of over \$25 billion in 1919. Both expenditures and the debt declined in the twenties but then began to rise in the depression-stricken thirties. As a result of World War II, both federal expenditures and the debt

soared to new all-time peaks. There was some retrenchment in the early post-war years, bringing reductions in both expenditures and the debt. The outbreak of hostilities in Korea and the "Cold War," however, brought another rise.

For the current fiscal year, the Federal Government is expected to spend nearly \$70 billion, and the debt is close to the wartime peak. To meet the needs of a growing and shifting population, state and local government expenditures have also risen substantially. Federal expenditures are now equivalent to 16 per cent of G.N.P., and if state and local government expenditures are included, the percentage is almost 25. The federal debt now constitutes one-third of all public and private debt outstanding. It is obvious that the fiscal and debt-management operations of the Government have become a far more powerful economic force than a few decades ago.

Government financing affects the amount of funds at the disposal of the public, both directly and indirectly. Treasury receipts, whether from taxation or the sale of securities to non-bank investors, siphons funds from individuals and business firms. The direct effect is a shift of spendable funds from the public to the Government. On the other hand, every dollar paid out gives someone another dollar to spend. Expenditures tend to return funds drained away by receipts, although not necessarily to the same persons or business firms. The direct effect on the total amount of funds at the disposal of the public depends primarily on whether the Treasury takes in more than it pays out. An excess of receipts tends to reduce spendable funds in the hands of the public; an excess of expenditures tends to increase them. The final effect, however, depends on how the surplus is used or the deficit is financed.

If a surplus is held on deposit in the Federal Reserve Banks or used to redeem securities held

by them, both the deposits and reserves of commercial banks are reduced. When used to redeem Treasury obligations held by commercial banks, banks regain reserves drained away by receipts but there is no immediate increase in deposits held by the public. Thus the use of a surplus to retire Government securities held by the banking system tends to reduce the amount of funds available for private expenditure. If, however, Government securities held by non-bank owners are redeemed, there is no direct effect on total bank reserves or the amount of funds in the hands of the public. A cash deficit increases the amount of funds in the hands of the public only when it is financed by borrowing from the banking system. Borrowing from others than banks may increase total spending, however, if it draws idle balances into use.

Treasury operations also affect the distribution of both income and expenditures. Receipts take funds away from taxpayers or the purchasers of Government securities. Whose spending power is reduced depends on where the Treasury gets its money. The progressive income tax, the most important source of receipts, tends to siphon more funds from the higher than the lower income groups.

Treasury expenditures also affect the distribution of total spending. It is most unlikely that funds transferred to the Government are distributed in the same way that taxpayers would have used the money. Large budgets for national security have tended to channel spending into the hard goods industries such as aircraft, munitions, machinery, and equipment. In effect, a part of personal and corporate income, which otherwise would have been used to purchase other types of goods and services, has been diverted to the purchase of defense supplies and equipment.

Treasury, fiscal, and debt-management operations may affect total spending indirectly through

their influence on bank reserves and the money market. Treasury receipts tend to reduce privately held deposits and also bank reserves. The drain on reserves occurs when Treasury balances are transferred from commercial banks to the Federal Reserve Banks or when receipts are deposited directly in the Reserve Banks. When the Treasury pays out checks drawn on the Reserve Banks in meeting its expenses, privately held deposits and bank reserves are increased as the checks are collected. The immediate tendency is for a surplus to reduce bank reserves and a deficit to increase them, although the ultimate effect depends largely on how the surplus is used or the deficit is financed. The Treasury tries to minimize the impact of its day-to-day operations on bank reserves by keeping its balance in the Reserve Banks steady.

Debt-management operations also affect interest rates and may have an important bearing on the effectiveness of monetary policy. The Treasury in choosing the types of new securities to be offered, both in new borrowing and in refunding maturing issues, may influence the distribution of Treasury obligations between bank and non-bank holders. If it chooses to issue securities attractive to the banks, the tendency is to increase bank holdings and the money supply. Long-term issues, however, are more likely to siphon in funds from savings institutions and other non-bank investors. Treasury borrowing and refinancing also affect the interest-rate structure and prices of securities, both Government and private.

Fiscal and debt-management policies may have a significant influence on the effectiveness of monetary policy. A restrictive policy may be seriously weakened by a federal deficit which tends to add to the money supply and vice versa. Frequent Treasury refunding operations create administrative difficulties for the monetary authorities. Restrictive monetary actions, for example, during

the refinancing of maturing issues might well endanger the success of the operation. If in fixing the terms on a new issue the Treasury misjudges the market and puts the rate too low, the Federal Reserve may have to make purchases in order that the offering will be successful.

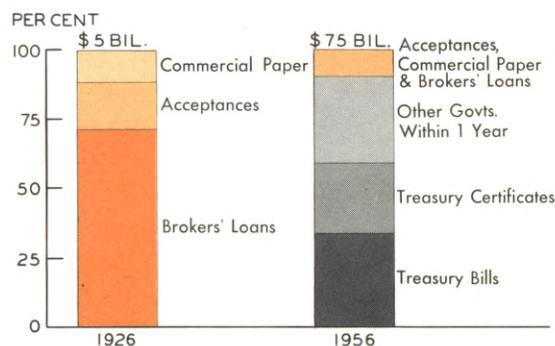
The money market

In simple terms, the money market is the place where deposit balances are transferred through purchases and sales of short-term paper and securities. Excess funds can be exchanged for liquid assets that earn income, and short-term securities can be exchanged for cash. Through the money market, the temporary excess funds of some are made available to meet the short-term needs of others.

The money market has undergone marked changes since World War I. There has been an almost complete change in the types of credit instruments traded in the market; the market has become much broader; and the development of new trading techniques and practices has increased the mobility of short-term funds.

Money-market instruments. Prior to the Great Depression, call loans and to a lesser extent time loans to brokers and dealers constituted the most important part of the money market. The bulk of

MONEY MARKET INSTRUMENTS (END OF YEAR)



these loans was made by the large New York City banks both for their own account and for the account of others. Most of the loans were callable at the option of either the lender or the borrower, and marketable securities were pledged as collateral.

The call-loan market served as an important outlet for the excess reserves of commercial banks. Interior banks with excess funds tended to deposit them in larger correspondent banks. The latter, in turn, would redeposit these balances with other correspondents so that ultimately a good part of excess reserves ended up in a few large banks in New York City. Such balances were the primary source of funds for call loans to brokers and dealers. A withdrawal of balances by interior banks was usually met by calling some of the loans to brokers. Brokers usually obtained the funds for repayment by borrowing elsewhere. The call-loan market was the principal facility for adjusting bank reserve positions—providing an outlet for their temporary excess funds and a source of funds for meeting their short-term needs.

The call-loan market, although performing these functions fairly well in ordinary times, broke down in periods of crises. To meet a wave of withdrawals by interior banks, the New York banks would have to call a large amount of brokers loans, which in turn would set off heavy liquidation of the securities pledged as collateral. As securities prices declined, margins were impaired, touching off still more sales.

Short-term commercial paper and bankers' acceptances were also bought and sold in the money market. The total volume outstanding, however, was usually considerably smaller than the amount of call loans.

The call loan has ceased to be a significant part of the money market. The amount outstanding is small as compared to other money-market instru-

ments, and banks usually do not call such loans to meet a deficiency. Commercial paper and acceptances are still traded but account for only a small part of the total volume of money-market transactions.

The Treasury bill and other short-term Treasury issues now account for the bulk of all transactions in the money market. Commercial banks and other institutions adjust their reserve and cash positions mainly by buying and selling Treasury bills and other short-term instruments.

A broader market. The call-loan market was used directly as a source or an outlet for funds by a relatively small number of commercial banks and other institutions. Indirectly, through the system of correspondent bank balances, it reached a considerably larger number. Banks also held a large part of the commercial paper and acceptances outstanding.

The growth of the federal debt was accompanied by a wider distribution of the ownership of U. S. Government securities. Sales promotion campaigns during the two world wars induced many to buy Governments who would not have done so otherwise. In recent years, many institutions, including commercial banks, other financial institutions, large business corporations, and foreign institutions, have become holders of Treasury bills and other short-term Governments. These institutions regard their holdings of short Governments as a liquid reserve to be drawn on to meet both expected and unexpected needs for funds. Institutions temporarily in need of funds thus become sellers and those with excess balances, buyers of short-term Governments. The wider distribution of short-term Government securities has given a growing number of institutions access to the money market, thus enabling them to even out their flow of receipts and expenditures.

Trading techniques. In the earlier part of the

century, funds were put into and withdrawn from the money market mainly by the granting and repayment of brokers loans. Note brokers bought short-term paper from the issuers and re-sold it mostly to commercial banks with surplus funds to invest. But only a minor part of money-market transactions represented the purchase and sale of short-term paper.

Today, outright purchases and sales of short-dated Government securities account for a good part of the activity in the money market. Other techniques, however, have been developed to meet the needs of market participants. In the past few years, the market for federal funds—deposit balances in the Reserve Banks—has grown rather rapidly. This market enables banks with excess reserves to lend them, typically for one day, to banks and others in need of immediate funds. A market for federal funds developed much earlier but fell into disuse during the thirties when banks had a plentiful supply of excess reserves, and during World War II and the early post-war years when the policy of supporting the prices of Government securities gave member banks access to Reserve Bank credit at very low cost. The funds market enables banks to put idle balances to work even for one day, whereas it might be unprofitable to buy bills one day and sell them the next because of the spread between the bid-and-asked quotations.

Another technique which seems to be growing is the sale of short-term securities under repurchase agreement—the seller agreeing to buy the securities back within a stated period or at the option of the buyer. Many of these transactions are also for one day, although some are for a longer period. Selling securities under a repurchase agreement is used especially by Government securities dealers to tap the temporary idle funds of banks and large corporations. Advantages to

the bank or corporate buyer as compared to an outright purchase of bills are that the risk of price fluctuation is eliminated, the interest rate usually compares favorably with the prevailing market rate on bills, and the purchaser can usually terminate the agreement at such time as he chooses.

CONCLUDING COMMENTS

Three things stand out in this brief review of the expanding role of the central bank and significant changes in our economy. First, the responsibilities of the Federal Reserve, as other central banks, have expanded as increasing attention has been directed toward methods for achieving a stable and growing economy. Secondly, Government, reflecting the impact of two world wars and a severe depression, has become big business. Its financial operations and policies exert tremendous influence on the level and the distribution of income and expenditures. Thirdly, the growth of commercial banks and other financial institutions has greatly enlarged the pool of available credit, and developments in lending policy have made this credit available for financing more types of economic activity. At the same time, developments in the money and capital markets have increased the mobility of funds both among regions and among institutions.

Whether and to what extent these environmental changes have influenced the effectiveness of monetary policy can be answered only by an extensive and thorough study of the many factors involved. Some of the changes apparently have facilitated achievement of the goals. The trend toward loans of longer maturity has resulted in the total volume of commercial-bank loans being geared less closely to short-term fluctuations in business activity. Likewise, the policy of investing residual funds in Government securities has had a similar result. In periods of recession, when the demand for loans

is usually weak, banks increase their holdings of Governments. In good times, when the demand for loans is strong, banks liquidate Governments to obtain funds for loans. As a result of this compensatory movement of loans and investments, total bank credit outstanding has become more stable. The impact of bank credit has broadened as banks have granted loans to more and more types of economic activity. Thus the total volume of bank credit has become less volatile and its impact on the economy more pervasive.

The growth of the money market along with more widespread holdings of Government securities has increased the mobility of funds. Funds are readily shifted from regions and institutions with temporary surpluses to those with temporary deficits. Thus the impact of monetary actions is transmitted more promptly to various sectors of the economy. On the other hand, larger holdings of Government securities and the more efficient mobilization of excess funds through the money market have increased liquidity with the result that the bite of restrictive actions may be cushioned while excess liquidity is being absorbed.

The effects of the growth of non-bank financial institutions and the sharp rise in federal expenditures and the debt on monetary policy are not so clear. Non-bank lenders such as savings institutions are not directly subject to Federal Reserve regulations. An increase or decrease in the loans and investments of these financial intermediaries does not expand or contract the money supply, as in the case of commercial banks. The total amount of credit they can extend is limited by their net

inflow of savings, in contrast to commercial banks which are limited by the amount of reserves they have to support the new deposits created. The growth of these financial intermediaries has not impaired the ability of the Federal Reserve to regulate the only type of credit that expands or contracts the total supply of spendable funds at the disposal of the public. Non-bank lenders, however, may affect total spending by transferring to borrowers, funds which would not have been spent otherwise. In this case, the stimulus to spending arises from an increase in the rate of turnover instead of an increase in the quantity of money.

The enlarged financial activities of the Federal Government may either contribute to or impair achievement of the goals of monetary policy, depending on how well the two are coordinated. Treasury surpluses and deficits of the proper amount and appropriately timed contribute materially to efforts to iron out business fluctuations. Advance preparation of the budget and the difficulty in forecasting business and financial developments make such timing extremely difficult, however. It is also difficult to conduct debt-management operations solely with regard to helping maintain economic stability. The policies of federal credit agencies, although unimportant in terms of the volume of their direct loans, influence the terms on which private credit is extended and therefore the demand for credit. Fiscal, debt management, and other financial operations of the Government, if properly coordinated with monetary policy, can make a significant contribution toward achieving the common goal of stable economic growth.

WAITING FOR SPRING:

The Automobile Picture As District Dealers See It

Robins aren't enough. Automobile dealers need further signs before they know spring is coming. They look for flocks of interested showroom visitors, requests for demonstrations and, most of all, a seasonal surge in sales.

They are more interested in spring than most of us because that's when business is best. The weather melts winter-bound sales resistance and people begin to think of riding around in a shiny new car—and many of them buy one.

The spring season often determines the success of the whole year. Sales for the crucial months of March through June were disappointing in 1956 and the year's total fell below expectations. The story that spring 1957 will tell is eagerly awaited.

How are things going in the District? To find out, we talked to about 40 dealers during the last week in March. Some were doing well but most were discouraged.

This attitude is a change from the atmosphere of confidence that surrounded the debut of the 1957 models. Dealers were smiling; the public liked the cars, and initial sales appeared to show it.

Then smiles faded. The usual March pick-up didn't materialize. Spring came to the calendar but not to the showroom. More than 40 per cent of the Philadelphia dealers told us March sales were running at or below mid-winter levels.

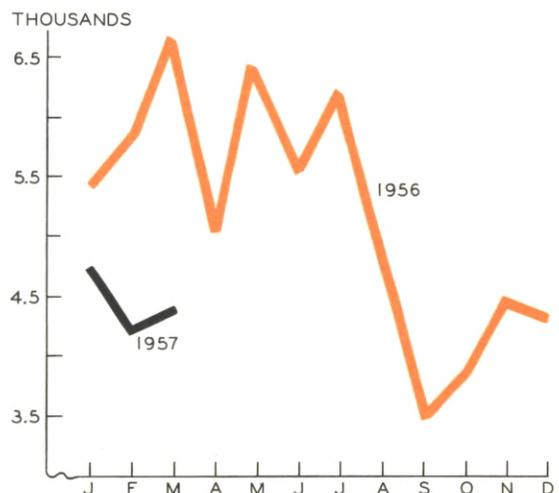
At the time we interviewed them, few dealers

had noticed any signs, sales or otherwise, that the spring selling season was beginning nor were they optimistic about the future. Only a third expected a "good" spring; the rest said, "fair" or "poor."

Total registration figures substantiate these individual experiences. The chart shows new passenger-car registrations in Philadelphia County for 1956 and 1957. The first quarter of this year was about 25 per cent below 1956, with a drop of 34 per cent from March to March.

SALES IN 1957 ARE WELL BELOW 1956 LEVELS.

New passenger car registrations—Philadelphia County



Reports from dealers in other sections of the District indicate that conditions are spotty. Local conditions, such as the settlement of a long strike or a big lay-off, are bound to be reflected in a particular area's automobile sales. Yet even from scattered sections a general feeling can be detected. The District's over-all tone, though better than Philadelphia's, does not sound good.

At this writing, we have only January and February registration figures for eastern Pennsylvania—they are down 15 per cent from a year ago. This drop compares favorably with Philadelphia County's 20 per cent but is worse than the estimated national decrease of about 4 per cent.

SOME BRIGHT SPOTS

We have been speaking of the over-all scene and that seems pretty bleak. There are some bright spots, however.

Despite poor sales, inventories are in fairly good shape. Very few dealers considered their new-car stocks excessive or unmanageable. Evidently production cuts have taken much of the pressure off dealers. This bodes well for saner selling tactics, since high inventory levels often instigate "blitz" sales and "crazy" deals.

Many dealers are happy about their used-car operations. Demand is strong, generally better than for new cars. Prices seem to be holding firm and inventories are normal to low.

Chrysler Company dealers say they are having a good year. The public likes the new styles, "fins" and all. Sales are strong and some dealers can't get enough of "hot" models, like Plymouth Belvederes and station wagons.

High-priced, prestige cars, such as Cadillacs and Continentals, are also in demand. So are many foreign cars. Small economy models from abroad are selling like the stack of hot cakes they somewhat resemble. Customer waiting lists, remi-

niscent of the immediate post-war period, have been revived for the most popular makes.

Yet these successes don't bulk large in the aggregate; they don't offset the majority of dealers who aren't doing so well.

WHY SALES ARE DOWN

We asked the dealers what, in their opinion, caused sales to decline this year. We got a lot of answers.

Lack of equity was the most frequent explanation. Many people still owe a large sum on their present car, sometimes more than its trade-in value. "A guy drives in and says he owes \$1,500 on his car," says one dealer. "When we tell him we can only give him \$1,300 on it, that kills the deal right then and there." Most drivers don't buy a new car until their old one is almost paid for or at least until they can get enough from its sale to provide a down payment.

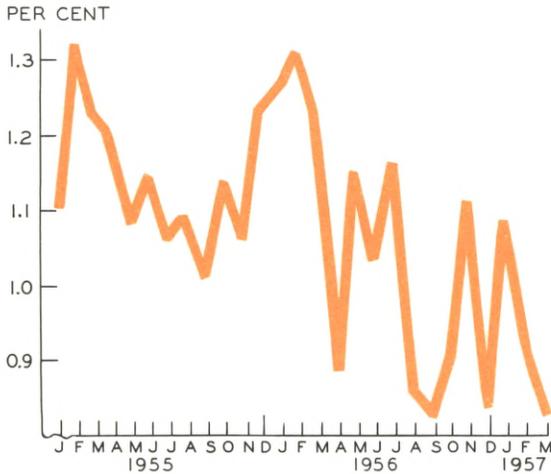
Why do owners have less equity than usual? The main answer lies in the extended maturities and low down payments that were used to spur sales in the record year of 1955. Easy-term selling in 1955 is keeping some people out of 1957's market.

Philadelphia's experience appears to underline the significance of financing terms. The next chart shows that Philadelphia registrations, as a percentage of the national total, have been on a downward trend since early 1956. Reports indicate that liberal terms, especially 36-month maturities, were more prevalent here than in the country as a whole. Perhaps these easier terms gave Philadelphia a special boost in 1955, and the consequent slower equity build-up helps to account for our declining sales percentage since then.

Quite a few dealers think buyer resistance to the higher prices of new cars has hurt sales. Basic cars are more costly and many expensive acces-

PHILADELPHIA'S SHARE OF THE NATION'S AUTOMOBILE SALES HAS BEEN DECLINING SINCE EARLY 1956.

New passenger car registrations—Philadelphia County as a per cent of the United States



sories have become almost standard equipment. The customer gets more but he also has to pay more and some customers are beginning to balk.

Dealers give valid evidence of price resistance. They report a trend toward "trading down" to cheaper cars; former owners of medium-priced cars are buying low-priced makes, and low-priced owners are settling for late-model used cars. Our survey results substantiate this trend. We found that dealers in the middle-price field were especially pessimistic about sales while used-car dealers enjoyed a brisk demand.

The customers seem to be holding back, was a common observation. Dealers noticed an unusual degree of public caution or buyer apathy for this time of year. It was hard to explain, for incomes are high and the new models have been generally well received. One dealer tried to pin it down by saying that recent depression talk has shaken public confidence. He believed that people are reluctant to go in debt and are holding on to their money with a "wait and see" attitude.

We asked if tighter credit conditions for customers were a reason for the sluggish sales. The replies were mixed. Over 50 per cent said no, not at all, while about 30 per cent gave an equally emphatic yes. The remaining 20 per cent thought tighter credit might have had some slight effect on their sales.

Curiously, a number of dealers, including some who felt their sales were reduced by tighter credit, were in favor of it. "Helps keep out the risky deals we wouldn't want anyway," they said.

Finally, the dealer himself, by conscious design, may have had something to do with his downward sales trend. He has sold a lot of cars in the past few years but has had to "discount" away part of his profit to do it. He's getting tired of the high-sales-low-profit paradox. Several dealers told us this year will be different. This year they're going to put the emphasis on profits not volume, aiming for fewer sales but more profit on each.

A SUCCESSFUL YEAR?

We didn't hear a cheerful story when we talked to District dealers last month. The spring selling season was weeks overdue and they were discouraged.

Yet things may not be so bad as they seem; spring may just be a little late this year. Sales may perk up any day now and bring back dealers' smiles. There's still plenty of time for a successful year.

Among the encouraging signs are manageable inventories which may enable the dealer to concentrate on profits rather than volume. Lack of equity, which is now slowing sales, is self-correcting. A few more monthly payments may do the trick and bring many repeat customers back in the market later in the year.

While the year's total sales will probably be lower than expected, the dealer himself might not do so badly after all.

CURRENT TRENDS

Talk about the business outlook has changed considerably since the turn of the year. At that time most “business outlookers” were anticipating another year of growth—a year during which the very broad totals would move in the same direction and by about the same magnitude as in 1956. For the past month or so “business outlookers” have been telling a more subdued story. 1957 is now to be a year during which the broad totals will move sidewise from fourth quarter 1956 levels.

Strangely, the facts do not seem to have changed nearly so much as the talk itself. Government spending still looks as though it’s going to rise by about twice as much as in 1956. Business spending on plant and equipment is expected to increase, according to the latest survey. The rise is not to be nearly so large as in 1956, but this was generally acknowledged at the turn of the year. Businessmen are revealing some hesitancy in their inventory buying. Their stock-sales ratios last December foreshadowed this consequence. Consumer buying so far this year has been somewhat lacklustre, but not exactly disappointing. If automobile sales pick up they would put a whole new face on the consumer sector.

Housing—below expectations

One major segment of the economy seems to be falling below most projections—housing. Private housing starts in February fell below 1 million on a seasonally adjusted annual basis for the first time in over 5 years. Preliminary reports indicate that the seasonally adjusted figure in March also will be below 900,000.

Most builders and real-estate operators say tight money is the big reason for the fall in housing starts. They’ll acknowledge that rising costs and prices, plus not as many marriages as a few years back, are factors in the decline. But to them, it’s still tight money that’s put the real crimp in housing.

They say housing has been quite sensitive to changes in credit conditions for the past few years. They point out that in 1953 housing starts fell below 1952 levels in spite of the generally more favorable business climate. Money was tight over most of 1953.

Starting in the fall of 1953, residential construction activity began perking up. That was about the same time that total spending in the economy headed downward and was some months after general credit conditions began to ease.

Throughout 1954 easy money conditions prevailed and housing boomed along unperturbed by the slump in other business activity. Ready availability of funds on easy terms encouraged builders to go ahead with large-scale programs. Lower down payments and longer maturities reduced out-of-pocket and monthly costs of buying new homes.

Housing zoomed in 1955 to some extent on the strength generated by easy money conditions that prevailed in 1954. As 1955 progressed, it became more and more apparent that the very strong showing was due to a flying start. In the fall of 1955, housing starts began consistently falling behind year-ago totals. In 1955 money conditions grew progressively tighter.

Last year, with tight money all the way, hous-

ing starts declined by 16 per cent. Expenditures on housing fell by 8 per cent as rising costs and larger houses offset some of the decline in starts.

So far this year, the situation in housing has continued to get worse. Recently some moves have been made to ease the mortgage credit situation. For example, the FHA rate has been raised to 5 per cent in an attempt to make these mortgages more attractive to lending institutions.

Government insured show wide swings

It is significant that over these past few years of shifting business and money policies, the big changes in housing starts have taken place in the Government insured and guaranteed portions. In 1956, FHA insured and VA guaranteed starts were down 31 per cent from the level in 1955. Conventionally financed housing starts were just 1 per cent lower over the same period. On the other hand, FHA and VA starts were 43 per cent higher in 1954 than they had been in 1953. Conventionally financed housing was down 6 per cent.

The "stickiness" of interest rates on FHA and VA mortgages seems to be the main cause of the wider swings in starts with such mortgages. When interest rates generally are on the rise and FHA and VA rates are held steady, these mortgages are less attractive to institutional lenders. Conversely, when interest rates generally are falling and FHA

and VA rates hold steady, these mortgages attract funds.

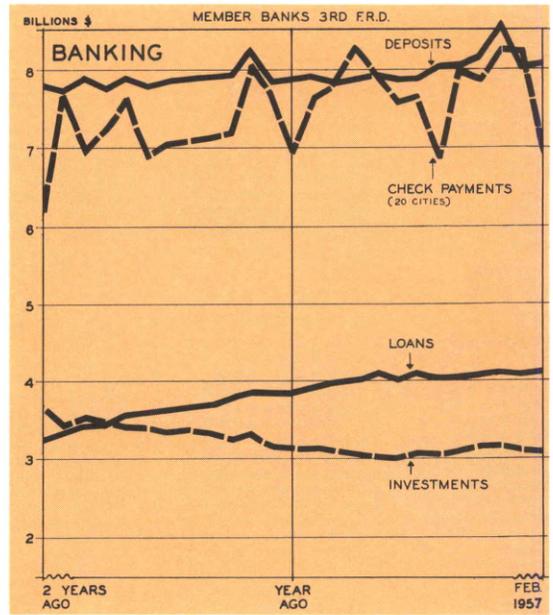
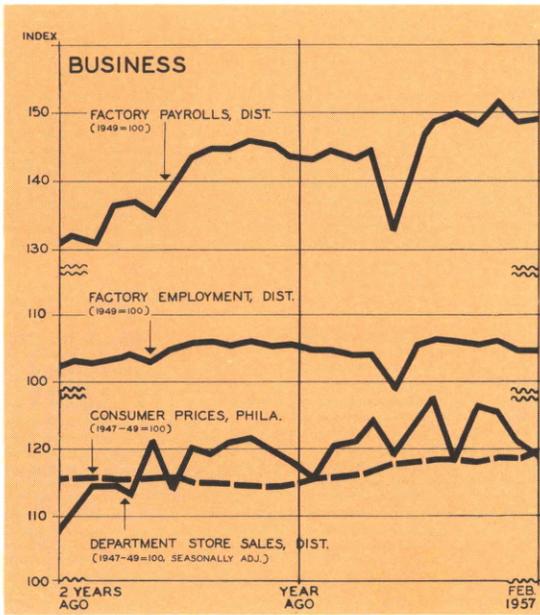
It has proven difficult for the FHA and VA to encourage starts within an overall tight money situation. In 1956 for example, FHA and VA raised maximum maturities to 30 years, and FHA reduced the required down payment on homes priced at \$9,000 or less from 7 to 5 per cent. Just recently further relaxations have been made. Most builders say these moves could aid starts, but are smothered by the fact that institutional lenders find so many other more profitable uses for their funds.

More funds for housing?

Some expect that as 1957 progresses mortgage money will ease. Competition for funds from businessmen for inventory and plant and equipment needs should not be as keen as in 1956, though state and local governments may take up much of that slack.

In any event, housing people hope the rise in the FHA rate to 5 per cent will "sweeten" those mortgages enough to attract funds going elsewhere. If mortgage money does ease perceptibly, it will be interesting to see if housing shows the same sensitivity as in the recent past. Give the industry a few months to adjust to the changed situation and it still seems a good bet that housing will go up if interest rates generally go down.

FOR THE RECORD...



SUMMARY

	Third Federal Reserve District			United States		
	Per cent change			Per cent change		
	February 1957 from		2 mos. 1957 from year ago	February 1957 from		2 mos. 1957 from year ago
	mo. ago	year ago		mo. ago	year ago	
OUTPUT						
Manufacturing production...	+ 1	- 3	- 4	+ 2	+ 2	+ 2
Coal mining.....	- 4	- 6	- 7	+ 2	- 2	- 5
EMPLOYMENT AND INCOME						
Factory employment (Total)...	0	0	0	0	0	+ 1
Factory wage income.....	0	+ 3	+ 2			
TRADE**						
Department store sales.....	- 2	+ 1	+ 1	- 1	+ 4	+ 3
Department store stocks.....	- 1	+ 2		- 1	+ 1	
BANKING (All member banks)						
Deposits.....	0	+ 2	+ 2	0	+ 2	+ 2
Loans.....	+ 1	+ 7	+ 7	0	+ 9	+ 9
Investments.....	- 1	- 2	- 2	- 1	- 5	- 5
U.S. Govt. securities.....	- 1	- 1	- 1	- 1	- 5	- 6
Other.....	- 1	- 4	- 3	+ 1	- 3	- 3
Check payments.....	- 15†	0†	+ 4†	- 13	+ 10	+ 9
PRICES						
Wholesale.....				0	+ 4	+ 4
Consumer.....	+ 1†	+ 4†	+ 4†	0	+ 4	+ 3

†20 Cities
‡Philadelphia

**Adjusted for seasonal variation.

LOCAL CHANGES

	Factory*		Department Store		Check Payments			
	Employment	Payrolls	Sales	Stocks				
	Per cent change February 1957 from		Per cent change February 1957 from		Per cent change February 1957 from			
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago		
Allentown...	+1	-1	-3	+ 8		-10	+ 6	
Harrisburg...	0	+ 4	+ 4	+ 18		-17	+ 4	
Lancaster...	0	- 3	+ 2	- 1	- 12	- 7	+ 14	- 2
Philadelphia..	0	+ 1	+ 1	+ 7	0	- 2	+ 9	+ 4
Reading.....	- 1	- 2	0	+ 2	- 5	+ 12	+ 9	+ 3
Scranton.....	+ 2	+ 1	+ 3	+ 6	+ 9	+ 2	+ 9	+ 6
Trenton.....	0	+ 2	+ 2	+ 6	- 10	+ 3	- 2	+ 2
Wilkes-Barre.	+ 2	- 1	+ 1	+ 5	+ 4	+ 4	+ 4	- 2
Wilmington...	0	- 3	0	+ 3	+ 6	+ 4	+ 12	+ 7
York.....	- 1	- 2	- 1	+ 1	- 3	+ 6	+ 9	+ 1

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