

# BUSINESS REVIEW

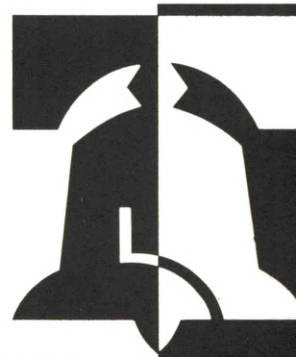
FEDERAL RESERVE BANK OF PHILADELPHIA

Aiming at a Moving Target: Environment  
and the Goals of Federal Reserve Policy

The Current Business Expansion: Where from Here?

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# AIMING AT A MOVING TARGET

## Environment and the Goals of Federal Reserve Policy

The German philosopher Arthur Schopenhaur had some interesting thoughts on the goals of human society. He thought we would all be better off if we ceased to reproduce and let the race die out. The reason for this dire prescription: life is a struggle; defeat and anguish are inevitable; so why bother.

Fortunately, Schopenhaur's views failed to capture the enthusiasm of his contemporaries. But his views do illustrate an important point in any discussion of social objectives: such objectives are the peculiar products of their times.

Take Schopenhaur's case, for example. The Napoleonic Wars had just ended. Europe was ravaged, millions of persons had perished, wretched poverty stalked the land. Moreover, the hopes of the French Revolution—liberty, equality, and fraternity—were little more than mocking echoes. Things seemed so bad that the famed German poet, Goethe, was moved to announce, "I thank God I am not so young in so thoroughly a finished world."

But of course times changed. In fact, the pessimism of the early nineteenth century was, in retrospect, no more than a ripple on the broad tidal wave of hope unleashed by the Renaissance and the Age of Enlightenment. Among other things, this hope sprang from development of the scientific method and the rapid accumulation of technical know-how. It suggested that man, by exercising his reason, could march ever upward in fulfilling his unique human potential and satisfying his wants.

### SOCIAL GOALS IN THE U.S.A.

This environment of intellectual and material progress was the backdrop against which the early social goals of the United States were formulated. The ideas of the Declaration of Independence are rooted here—that all men are created equal and have inalienable rights such as life, liberty, and the pursuit of happiness. The Constitution drew upon this broad movement, in stating such objectives of union as that of promoting the general welfare.

The subsequent evolution of economic objectives in the United States has amounted, in large measure, to a searching refinement of the "general welfare" goal. Given the background heritage that progress was possible (and given the stated objective that Government should promote that progress) this nation constantly has been involved in a revision of the *idea* of progress. What was good enough became not enough.

In this article we take a look at shifting ideas of the goal of progress with emphasis upon the character of the times which generated these shifts. Our focus is upon money and the Federal Reserve System, how the System reacted to and was stimulated by the changing times and how it altered its goals better to coincide with the evolving idea of progress.

### THE SHIFTING IDEA OF PROGRESS AND THE EVOLUTION OF FEDERAL RESERVE GOALS

In the Employment Act of 1946, Congress di-

rected the Federal Government to coordinate all its activities toward the end of “promoting maximum employment, production, and purchasing power” and to do so “in a manner calculated to foster and promote free competitive enterprise.”

In essence, Congress carefully defined two broad sets of economic goals, (a) what might be called “performance goals” (maximum employment, etc.) and (b) what could be termed “environment goals” (free competitive enterprise).

These two broad classifications of goals, in fact, have characterized the objectives of the Federal Reserve System since its very early days. Both explicitly and implicitly, the System has sought to maintain economic stability within the framework of a free enterprise system. This is a thread of continuity that binds past to present.

Yet as conditions changed through time—as we experienced wars, inflations, and recessions—subtle changes occurred both within and between these two broad sets of goals.

The performance objective changed in the direction of greater dynamism; from avoiding money panics to mitigating the boom-recession phase of the business cycle; from meeting the needs of commerce and industry to actively stimulating commerce and industry, and promoting real growth.

The environment objective also shifted. Though the Fed still sought a free-enterprise environment in pursuing its performance goals, it found that its *own* functioning could not be guided solely by the forces of free enterprise. It could not be so integral a part of the free enterprise system that its actions were limited by this system. It could not, for example, be stimulated to action solely by such free-market phenomena as “gold flows” and “productive credit.”

So much for the direction of movement. Let

us go back in history and trace the factors motivating change.

### **BIRTH OF THE FEDERAL RESERVE SYSTEM**

The immediate stimuli which motivated Congress to establish the Federal Reserve System were the severe money panics of the nineteenth and early twentieth centuries.<sup>1</sup> The influence of the panics is clearly evident in the Federal Reserve Act, which defines the *performance* objectives of the new System in such terms as furnishing an elastic currency and affording a means to rediscount commercial paper.

### **Economic performance**

In effect, the System was to provide funds to member banks which needed additional resources to meet the currency demands of their depositors or to pay balances due other banks. The funds could be obtained by a banker through a simple process: going through the notes owed him, selecting one or more deemed eligible, presenting them to a Federal Reserve Bank for discount. If banks had enough eligible notes, they would always be able to get funds from the System and thus could avoid any panic on the part of customers who might fear that currency would not be forthcoming on demand.

But the framers of the Federal Reserve Act had more in mind than preventing panics. The System was also to accommodate the “legitimate” credit needs of a growing economy through its discount function—through provision of funds and by setting the rate of discount—and prevent “ill-advised” credit expansion.

To meet credit needs, the Act authorized the Reserve Banks to “discount notes, drafts and bills of exchange [for member banks] issued or

<sup>1</sup> For a discussion of the character and mechanics of panics, see *Business Review*, Federal Reserve Bank of Philadelphia, “Who Changed the Rules of the Game,” October 1963, p. 4.

drawn for agricultural, industrial or commercial purposes, or the proceeds of which have been used, for such purposes. . . .” Banks could then use the proceeds of the discounts to make loans to their customers. Thus the process of discounting was the way both to prevent panics and provide funds for legitimate business growth.

The *Annual Report* for 1914 summed up the Board’s idea of its objectives when it mentioned 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.*<sup>2</sup>

These, then, might be termed the early “performance” objectives of the System. But how were the “environmental” objectives expressed?

### **Economic environment**

There was no explicit mention in the Federal Reserve Act of a free market environment. Yet much was implied and much more was taken for granted. To understand the environment which the Federal Reserve hoped to foster, it is necessary to understand the economic thinking inherited by the System.

1. *Free Enterprise.* Nineteenth century, laissez-faire liberalism was the legacy of the Federal Reserve System. Free enterprise was the byword—businessmen should be allowed to compete in the production and sale of goods with a bare minimum of interference by Government. It was thought that this system would assure maximum output at lowest cost and hence provide the greatest possible satisfaction of economic wants.

2. *International Trade.* But nineteenth century, laissez-faire ideas encompassed more than *domestic* production and trade. The System envisaged a free *international* market place in which the businessmen of each nation would (a) specialize in producing those goods they could make at lowest comparative cost and then (b) trade with each other across international boundaries, relatively unencumbered by tariffs and the like. It was thought that such a system would provide the most goods at the lowest prices. The system also envisaged the free movement of capital funds—an important invisible raw material of the production process.

3. *The Role of Money.* Yet the system might need new money and credit if it were to grow healthily. Rich resources were available for exploitation. New undertakings could be established and new production set going if money and credit were available. Sufficient funds, however, might not be forthcoming out of savings. What was needed was new money and credit to create a new circuit of production and then to circulate an ever-expanding volume of trade. This was to be provided through banks.

4. *Self-Regulating Nature of the Laissez-faire System.* But what was to make the system run smoothly? Businessmen might produce too much of the wrong kind of goods and not be able to sell them (thus creating unemployment of workers as goods stacked up). Moreover, too much or too little new money might be created thus causing inflation on the one hand (too much money pursuing goods) or inhibiting expansion on the other (not enough money to take advantage of productive opportunities). Finally, since the system included international trade, might we spend too much abroad and thus lose gold?

The answer to these questions—or so it was thought—was that the system was self-regulating,

<sup>2</sup> Federal Reserve Board, *Annual Report*, 1914, p. 17.

that the system itself generated forces that would maintain its own equilibrium and its own stability.

“Say’s law” of markets, for example, was widely accepted: supply creates its own demand—the process of production places income in the hands of the producers which is used to purchase the fruits of production. Thus the system tended toward operation at full capacity and full employment. Flexible wages, prices, and profits were supposed to assure the timely movement of capital and labor from industries where demand was falling to those experiencing rising demand.

And what of money? As it did in the production and distribution spheres, the *laissez-faire* system was supposed to generate its own equilibrating forces. If commercial bankers and central bankers would only recognize these forces, then it was thought that the equilibrium of the system would not be endangered by financial excesses. There would tend to be just the right amount of new money and credit to assure high-level production at stable prices.

On the home front, the mechanism was the “real bills doctrine.” The Federal Reserve should create new money (via the discount mechanism) only on the collateral of productive loans made by banks to finance current production and distribution—goods in process. Thus it was argued that each new creation of money and credit would match the needs of the production process. If production grew, so would money and credit. The free-enterprise system generated the demand for productive loans and this demand was the very force that would maintain financial equilibrium. All the central banker need do was recognize it and adjust his discount administration and rates accordingly.

Finally, how about the problem of international trade, of buying too much abroad (or in-

vesting too much) and hence losing gold? Again, the system generated self-stabilizing forces, or so it seemed.

A nation would buy too much abroad, it was thought, because prices were lower abroad. It would invest too much because interest rates were higher.

Increased purchases and investments abroad would mean a flow of domestic currency (and bank deposits) to foreign lands and quite possibly, an outflow of gold. This was where the self-corrective force became manifest.

Since gold was the basis of a nation’s money and banking system in the classical model, (currency and bank deposits were supposed to be backed by gold and interchangeable for gold) the *outflow* of gold was supposed to inhibit further creation of money and credit. Commercial bankers, seeing their gold reserves shrink, would be more reluctant to make new loans and create new demands against their diminishing gold reserves. Central bankers, aware of the outflow of gold, would raise their discount rates thus discouraging banks from rediscounting their paper and obtaining the wherewithal to create new money and credit.

The result? Less money and credit would be available. With less money and credit pursuing domestic goods, prices would tend to fall. With less money available to borrowers, interest rates would tend to rise. Domestic prices and interest rates would become competitive with their foreign counterparts and domestic citizens would cease spending too much abroad.<sup>3</sup> The *laissez-faire* system generated forces from within that maintained international as well as national equilibrium. We could have the benefits of free enterprise and free trade together with the bene-

<sup>3</sup> The reverse of this process was supposed to take place in the countries gaining gold.

fits of money creation to set in motion new circuits of production and trade. In short, we could have a growing supply of low-cost goods to satisfy our wants with a minimum of disturbing business fluctuations.

One might look at the laissez-faire system as a “package deal.” Theoretically, the buyer got all the free-market and output advantages without need to make agonizing discretionary decisions on how to maintain the stability of the system. All he had to do was *recognize* the stabilizing forces and play by the rules of the game, just act appropriately with regard to gold flows and “real bills.”

Thus the Fed, at its inception, was committed to an *environment* goal of free markets. But the environment goal was a package in which the Fed also accepted the inherent forces which would stabilize the system. In short, the Fed took on a responsibility to propagate the *whole* system, to gain the benefits and maintain the viability of the classical model by playing its rules.

And the environment goal seemed in perfect harmony with the performance goal. Performance was directed at stability—at avoiding panics and preventing “ill-advised expansions or unnatural restrictions of credit.” The *environment* objective seemed to promise just that—to provide both the natural forces and the automatic guides to action which would maintain stability.

The Fed’s commitment to the laissez-faire system was implicit in the Federal Reserve Act which prescribed the nature of bills which could be discounted and required that Federal Reserve notes be backed by gold. The commitment was also evident in System statements and publications.

A neat package it would seem. But the fact is,

things didn’t work out. For times were changing. Events were to test both the laissez-faire system of goals and the prevalent idea of progress on which those goals were based. The test was business depression—1920–1921 and the dark years of the thirties.

### THE MURKY ERA OF THE TWENTIES AND THE THIRTIES

The tests didn’t come for a while. The Fed was busy with organizational problems during its early days. Then World War I came along and all objectives became secondary to a successful financing of the war effort. For several months following the war, the Fed felt compelled to devote its efforts and resources to aiding the Treasury with the large war debt (which meant making credit readily available and keeping interest rates low). Then, in 1919, conditions seemed ripe once more to bring the objective of economic stability to the fore.

#### The twenties

In the year or more preceding 1920, fundamental economic developments as viewed by the Fed were deteriorating to the extent that economic goals seemed in imminent danger. Credit was being used for “speculative” purposes, which seemed to threaten economic stability and undermine both performance and environment goals. Moreover, gold was flowing out. The situation was described as:

*characterized by an unprecedented orgy of extravagance, a mania for speculation, overextended business in nearly all lines and in every section of the country, and general demoralization of the agencies of production and distribution.*<sup>4</sup>

<sup>4</sup> Federal Reserve Board, *Annual Report*, 1920, p. 1.

Given these conditions, the Fed raised discount rates both at the close of 1919 and again in May, 1920. The Reserve authorities felt that credit should do its part in bringing about readjustment, that borrowing should be made sufficiently expensive to exert pressure and discourage unproductive and unnecessary uses of credit. But the movement should be gradual and orderly; sudden credit or price deflation might lead to disaster.

Was the Fed successful? Unfortunately, no. There followed in 1920–21 the sharpest price break in history and a severe business recession.

This untoward train of events set the stage for a fundamental reexamination of Federal Reserve policy. Many members of Congress, Federal Reserve officials, and others felt that the recession was inevitable and necessary. Others, however, felt that Fed goals had not been attained and asked why.

This interrogative attitude was expressed succinctly in the Federal Reserve Board's *Annual Report* for 1923. In this document the classical laissez-faire model—the proud construction of the nineteenth century—came in for quite a humbling review. First to feel the swordpoint of analysis was the “real bills doctrine.” The Reserve Board pointed out that the theory was erroneous, that concentrating on the *quality* of credit would not automatically assure that (a) credit would be used for nonspeculative purposes or that (b) the over-all quantity of credit would be just sufficient to meet the needs of trade.

*There are no automatic devices or detectors for determining, when credit is granted by a Federal Reserve Bank in response to a rediscount demand, whether the occasion of the rediscount was an extension of credit by the member bank for non-productive use. Paper offered by a mem-*

*ber bank when it rediscounts with a Federal Reserve Bank may disclose the purpose for which the loan evidenced by that paper was made, but it does not disclose what use is to be made of the proceeds of the rediscount. A farmer's note may be offered for rediscount by a member bank when in fact the need for rediscounting has arisen because of extensions of credit by the member bank for speculative use.*<sup>5</sup>

Moreover, the Board pointed out: *By what means may it be known whether the volume of credit provided by the Federal Reserve Banks is in any given set of circumstances adequate, excessive, or deficient? The problem in good administration under the Federal Reserve System is not only that of limiting the field of uses of Federal Reserve credit to productive purposes, but also of limiting the volume of credit within the field of its appropriate uses to such amount as may be economically justified—that is, justified by a commensurate increase in the nation's productivity.*<sup>6</sup>

The question of the international gold standard also came up for review. The Board concluded that it was desirable to return to the standard but:

*Under the present conditions, with gold embargoes in force in most foreign countries and the United States practically the only free gold market of the world, the movement of gold to this country does not reflect the relative position of the money markets nor does the movement give rise to corrective influences, working through exchanges, money rates, and price levels, which tend to reverse the flow. The significance which movements in the reserve ratios formerly possessed rested upon the fact that they were the visible indicators of the operation of the*

<sup>5</sup> Federal Reserve Board, *Annual Report*, 1923, p. 35.

<sup>6</sup> *Ibid.*, p. 33.



*nicely adjusted mechanism of international finance. With this mechanism now inoperative, the ratios have lost much of their value as administrative guides.*<sup>7</sup>

To sum up the reevaluation prompted by the inflation-deflation cycle of the early twenties, the idea of progress could still be interpreted broadly within the old context: an environment goal of free enterprise, a performance goal of economic stability. Yet important shifts within and between the goals had occurred.

With regard to performance, panics no longer appeared to be a problem; concentration now was even more strongly on cyclical fluctuation in business.

As for environment, the nineteenth century laissez-faire model viewed as an integral whole had received some hard knocks. Fed officials had, in effect, adjudged it incompatible with the performance goal. Though a return to the gold standard was hoped for, the "real bills doctrine" was logically debunked as a technique to insure the economy against speculation and assure the proper over-all quantity of money and credit.

This is not to say that "real bills" ideas were completely dead. Such sharp breaks with the past are rare indeed. But, metaphorically speaking, the doctrine stood with hat in hands and head bent in humility. The Fed was moving away from the automatic formulae of laissez-faire toward discretionary money management.

Yet equally significant changes were still to come, both in the idea of progress and in the goals of policy to implement changing ideas.

Next in line as a social catalyst: the Great Depression of the 1930's.

### **The thirties**

The decade of the thirties marked the most

serious and protracted period of unemployment in the nation's history. In 1933, for example, one out of four persons in the labor force could not find a job. This compares to about one out of eighteen today, and even now we think of unemployment as a serious problem.

The early thirties were also years of financial crisis, when banks failed by the score and stock prices plunged. And the depression was not confined to this country. All of the industrial nations of the world suffered, and each attempted to protect itself, even through pushing this suffering onto the other with beggar-my-neighbor policies of tariffs, exchange controls, and the like.

Given these conditions, the idea of progress shifted from *maintaining* stability to *regaining* it—putting people back to work, reflatting prices, reestablishing confidence in banks and the financial system. Arthur Hersey of the Board's staff summarized the change in the following manner:

*After 1929 the dislocation of normal economic processes and the depressed level of business activity and national income made it necessary to reinterpret the twofold objective of maintaining prosperity and of maintaining sound credit conditions. It was no longer a question merely of smoothing out fluctuations in a generally stable economy. During the years 1930-1933 the immediate need was to restore the stability and adaptability of the banking system . . . "Soundness" of "credit conditions" . . . now involved the ultimate issue of public confidence in the banks and the basic ability of the banks to function effectively. The banking crisis of those years, unlike the money panic of 1907, was not to be cured simply by providing the banks with facilities for borrowing . . .*

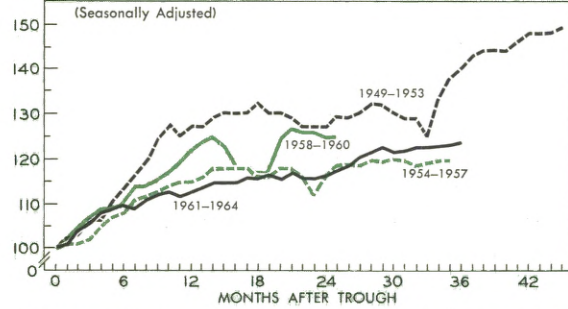
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<sup>7</sup> *Ibid.*, p. 30.

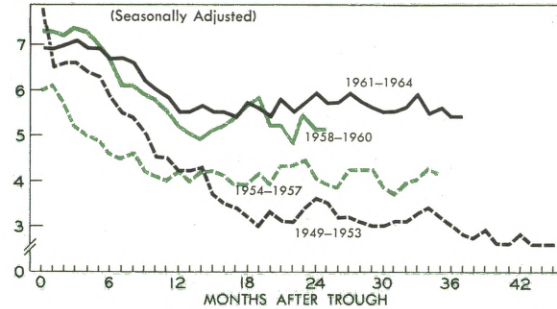
# THE CURRENT BUSINESS EXPANSION: WHERE FROM HERE?

The current expansion in business, which has been going on for over three years, has now become the longest since World War II (not counting the one from 1949-53 which was stretched out by the Korean action). The question now is what the tax cut will do to the course of the expansion. No one knows for sure, but part of the answer may lie in the nature of the growth we have had so far. These charts compare the growth in this period with those of other expansion periods in the postwar years, starting with the bottom of the recession as 100.

**INDUSTRIAL PRODUCTION**  
INDEX (Trough = 100)



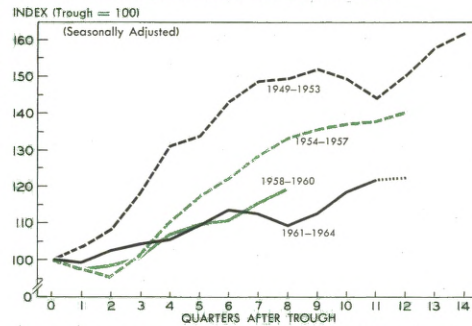
**UNEMPLOYMENT RATE**  
PER CENT



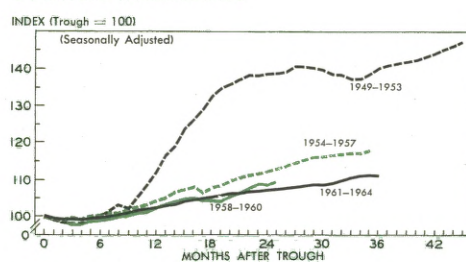
If two words can characterize the period, they are "slow" and "inadequate." This has been a relatively slow and gradual expansion. The course of industrial production during the current expansion has been quite similar to that after the 1954 recession, but generally at a lower level. In recent months, output has been relatively steady. And the pace has been too slow to take up unused resources. The unemployment rate, despite a high level of output, has been running considerably above the percentages of the comparative recoveries and hasn't shown any direction for many months. Much the same is true of the rate of idle manufacturing capacity.

One big reason the expansion has been relatively slow and inadequate is that this has not been a capital boom. Plant and equipment expenditures are scheduled to pick up steam after a lack-lustre first quarter, but their rate of increase is expected still to lag considerably behind the pace of the other recovery periods.

**PLANT AND EQUIPMENT EXPENDITURES**



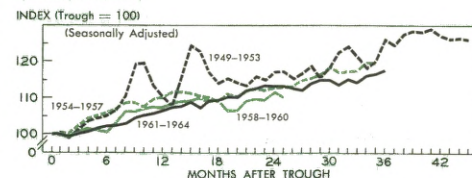
**BUSINESS INVENTORIES**



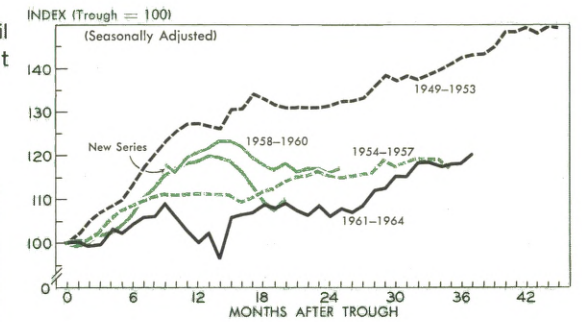
Businessmen also have been prudent about spending for inventories, increasing stocks more modestly than in earlier expansions.

Perhaps not quite so conservative as businessmen, consumers nevertheless have not been indulging in a spending spree. Although setting new record highs for three successive months, retail sales still have not risen so much as after the 1949 and 1954 recessions. Construction outlays also have shown less vigor; until the most recent month, the rate of advance had about come to a halt.

**RETAIL SALES**

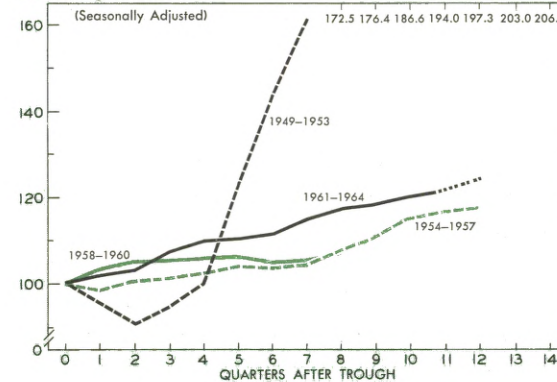


**NEW CONSTRUCTION OUTLAYS**



Construction outlays also have shown less vigor; until the most recent month, the rate of advance had about come to a halt.

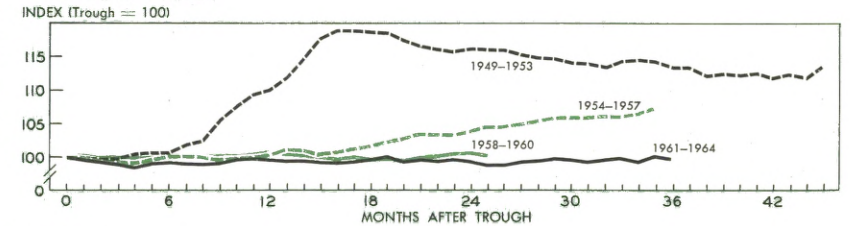
**GOVERNMENT PURCHASES OF GOODS AND SERVICES**



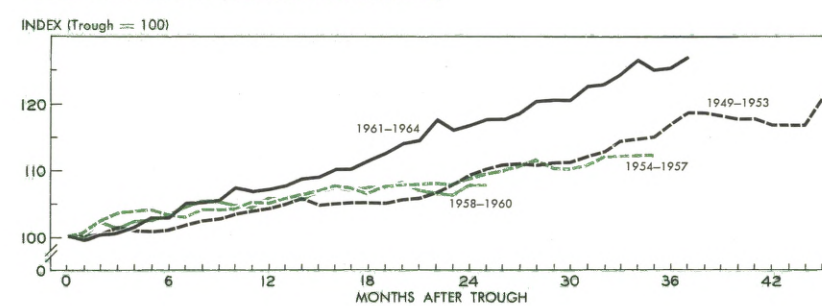
It is Government purchases of goods and services which have given the really impressive support to the economy over the past three years, increasing relatively more than in any of the other periods except during the Korea episode.

And because of all this the Federal Reserve has pursued an easy money policy which has promoted a much more rapid growth in bank credit than during earlier periods.

**WHOLESALE PRICES**



**TOTAL BANK CREDIT (Loans and Investments)**



Perhaps characterizing the moderate nature of the period better than any other has been the stability of prices. Although consumer prices have risen at about the same pace as in earlier expansions (except during Korea), wholesale prices have remained strikingly steady.

In short, this expansion has lasted longer than the others perhaps because it has been slower. This very moderateness gives rise to hopes that the upturn can continue. We shall have to wait, of course, to see how the tax-cut experiment turns out; but the nature of the expansion so far suggests that the tax cut will help to sustain and stimulate a somewhat lagging economy rather than put the bloom on a boom.

(Continued from Page 9)

1934 to the present time [1940] the Federal Reserve System has continued to orient its monetary policy toward the goal of a lasting recovery.<sup>8</sup>

But what, meanwhile, was happening to the *environment* objective? In a sentence, the laissez-faire model was disintegrating under the pressure of the day. Such a model seemed more and more inconsistent with the dire need to bolster the domestic economy.

*Free trade?* Legislators decided that importing *goods* meant exporting *jobs*. The answer—tariffs: the Smoot-Hawley Tariff of 1930, for example, greatly increased the price of a wide range of imported goods. Other countries as well instituted tariffs, and most also established embargoes, quotas, and exchange controls.

*Real bills?* The theory which had stood with hat in hands in the twenties was ushered out the door in the thirties. The Glass-Steagall Act of 1932 empowered the Reserve Banks to make advances to member banks that did not have adequate eligible and acceptable paper. Later, the Banking Act of 1935 said that “any Federal Reserve Bank . . . may make advances to any member bank on its time or demand notes . . . which are secured to the satisfaction of each Federal Reserve Bank.”

*Gold flows?* The problems of the twenties were posed with new intensity in the thirties. With tariffs and controls over imports and with exchange controls over capital flows in many nations there was no reason to expect a quick and sure response abroad to domestic changes in prices and interest rates, hence there was no reason to adhere to the gold standard

“rules of the game”—to react automatically with greater credit ease or restraint in response to gold inflows and outflows. There was a complete breakdown of the classical gold standard.

There was also a developing reluctance to allow international developments to affect domestic policies adversely. After 1931, gold inflows were the rule in the United States. The large volume of excess reserves which resulted acted as a sort of cushion. Loss of gold no longer limited freedom to pursue domestic objectives.

The *general* unwillingness to let international events overshadow domestic policies was well illustrated in the Board of Governor’s 1936 *Annual Report*:

*On September 25 the Governments of the United States, France, and the United Kingdom issued similarly worded statements in which each Government declared ‘its purpose to continue the policy which it has pursued in recent years, one constant object of which is to maintain the greatest possible equilibrium in the system of international exchange and to avoid to the utmost extent the creation of any disturbance of that system’ . . . Each Government stated that it must, of course, in its policy towards international monetary relations take into full account the requirements of internal prosperity.*<sup>9</sup> (Emphasis supplied)

In summary, the desperate need to secure *performance* goals—to rise from the abyss of depression—resulted in a rapid revision of the *environment* goal. The nineteenth century laissez-faire model was judged inappropriate for the conditions of the thirties. Free multilateral trade became a distant dream from the past. Gold-flow rules and “real bills” were scrapped.

<sup>8</sup> Arthur Hersey, *Historical Review of Objectives of Federal Reserve Policy*, Federal Reserve Bulletin (Washington: Board of Governors of the Federal Reserve System), April 1940, p. 10.

<sup>9</sup> Board of Governors of the Federal Reserve System, *Annual Report*, 1936, p. 6.

And to top things off: the Fed had even been given a *direct* control over credit markets! The Securities and Exchange Act of 1934 empowered the Federal Reserve Board to prescribe minimum margin requirements for purchasing or carrying securities or selling them short.

A man could still go out and start a grocery store and compete with the fellow down the street—we still wanted free markets at home. But for the time being the old environment was done for.

### End of the depression

The grim years of the Great Depression finally died away. The muffled voices of men in bread lines, the fears of unemployment, want, poverty—all were stilled. Now a new force was seething in Europe. The clank of metal on metal and the sound of jackboots in the streets signaled the emerging threat, then the awful climax and culmination of World War II.

Yet at war's end the specter of the Great Depression returned, its influence not yet spent. The shape of our postwar goals was to bear the indelible imprint of the experience of the thirties.

### THE EMPLOYMENT ACT OF 1946

An article appearing in the February, 1945 issue of *Harper's* expressed well the concern of the nation over postwar economic prospects: *During less than two years of war we tripled our ocean tonnage, and we will go into the peace with a merchant marine at least equal to that of all other nations combined. Obviously we will not need to build very many more ships for some time to come. The huge chemical factories can hardly expect stump-blowing and highway blasting to require explosives on anything like the scale demanded by the siege of Aachen or the bombing of Tokyo. Plane demand, accord-*

*ing to the Aeronautical Chamber of Commerce is likely to skid by 85 or 90 per cent, and with it will go the demand for astronomical tonnages of aluminum and magnesium. The machine tool industry has turned out enough equipment during the war, in the estimation of some manufacturers, to supply the needs of the next twenty years. And so on. How many jobs can such industries safely promise?*<sup>10</sup>

### Debate over postwar performance goals

Such haunting possibilities greatly concerned Congress as it deliberated the course of postwar economic policy. Add to this memories of the recent depression and there seemed no cause for optimism. Statements such as the following were included in materials prepared to aid Congress in its deliberations on economic policy. *In the early 1930's about one-third of our workers were unwanted, and all the rest shared in the fear of being unwanted. These injuries to human dignity will not again be tolerated by a free and self-reliant people.*<sup>11</sup>

And other basic dimensions of this same theme were considered. Throughout the hearings which preceded passage of the Employment Act one is struck by the resounding concern over the possibility of social conflict—conflict of ideology which might spring forth in either peaceful or violent form if the nation should once more be racked with depression. Concerning the former, Senator Wagner was quick to comment: *Recent events in other democracies convince me that this fundamental economic truth [the desirability of full employment] is permeating the minds of more and more people. Interpretations*

<sup>10</sup> Stanley Lebergott, "Shall We Guarantee Full Employment?" *Harper's Magazine* (Vol. 190, No. 1137, February 1945), p. 194.

<sup>11</sup> U.S. Senate, Committee on Banking and Currency, *Assuring Full Employment in a Free Competitive Economy*, 79th Congress, 1st session, staff report, September 1945, pp. 5-6.

of the [meaning of the] recent British elections are as thick as a field of daffodils. . . . They [the British people] were not satisfied that the government in power was sufficiently resolute in its determination to achieve postwar full employment, and so they have elected another government which is pledged to that purpose.<sup>12</sup>

But the fear of social conflict lay rooted in soil deeper than that of the ballot box. For in the despair of depression many saw the seeds of man's basest emotions, both as an individual and as a social animal. In the words of the Full Employment Subcommittee:

*When there are too few jobs to go around, bitter conflict develops between groups and individuals. Under these conditions, human virtues lose significance. The ethics of society recede to the ethics of the jungle, where dog eats dog. Racial and personal hates emerge. Group is set against group and class against class. The forces of intolerance and fear come forth in racial and religious conflict.*<sup>13</sup>

This, then, was the atmosphere in which Congress debated the provisions of the Employment Act of 1946. One basic question seemed to be at issue: could men endure and could this nation stand another depression like that of the 1930's? It appeared that we must *perform* better—raise our sights or we risked grave consequences.

Yet as we have seen, where *performance* is debated, *environment* is not far behind.

### **The environment goal:**

#### **Maintenance of free economic institutions**

Despite fear of unemployment and social conflict, the hearings and reports on postwar em-

ployment legislation were tempered throughout by a desire to avoid "overstepping the bounds of propriety" in setting and implementing national economic objectives for a free enterprise economy.

It goes without saying, of course, that Congressional judgments differed as to the geography of these bounds. An outstanding feature of the initial legislation was the high degree of emphasis placed on Government spending to combat depressions.

In both Houses the tussle over the bill resulted in a progressive de-emphasis of this specific stabilization device in favor of a more comprehensive technique of analysis of all sources of instability in the economy and attack along a broad front with remedial actions of many sorts.

The environmental metamorphosis may also be seen in Senator Taft's questioning of that section of the original bill which stated that: "All Americans able to work and willing to work have the right to useful, remunerative, regular, and full-time employment. . . ."

"What was the nature of this right?" inquired Senator Taft, "Is that a legal right, intended to create a legal right that a man can sue on if he doesn't get it, or what is the nature of that? . . . is that a right like the Bill of Rights, that a man can enforce in court?"<sup>14</sup>

It was this type of questioning and analysis which assured that the Act as finally passed would reflect the environment goal of free enterprise, even if that goal should be considerably modified from the days of *laissez-faire*.

This, then, is the heritage of the Employment Act of 1946, an attempt to provide economic stabilization within the confines of free economic

<sup>12</sup> U.S. Senate, Subcommittee of the Committee on Banking and Currency, *Full Employment Act of 1945*, 79th Congress, 1st session, hearings, July-September 1945, p. 2.

<sup>13</sup> U.S. Senate, Committee on Banking and Currency, *Assuring Full Employment in a Free Competitive Economy*, *op. cit.*, pp. 4-5.

<sup>14</sup> U.S. Senate, Subcommittee of the Committee on Banking and Currency, *Full Employment Act of 1945*, *op. cit.*, p. 20.

institutions. Senate hearings on the Act began on July 30, 1945. After months of exhaustive study in both House and Senate, after testimony and counter testimony, examination and cross-examination a joint conference committee finally agreed upon the specifics of the bill.<sup>15</sup> It was passed by unanimous voice vote in the Senate and by a 322-84 majority in the House. The President signed the bill on February 20, 1946 and the Employment Act of 1946 became Public Law 304.<sup>16</sup> It read in part:

*The Congress hereby declares that 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.<sup>17</sup>*

This was the substance of the Employment Act. Once more was expressed the subtle balance of performance and environment goals—the dedication to employment, production and purchasing power on the one hand and to free

competitive enterprise on the other.

Yet if the Act stressed the traditional objectives it also recognized the gradual shaping and molding of these objectives.

The Act called for free competitive enterprise but not for the laissez-faire environment of earlier years. Controversy concerned mainly the technique and degree that Government should intervene to maintain economic stability.

But perhaps most important, the Act expressed an important change in the *idea* of progress and in the *responsibility* for progress. The Act was legal recognition of the gradual evolution of the performance goal—from an emphasis on panics and accommodation of the needs of business; through a rather grudging acceptance of responsibility for mitigating fluctuations in the business cycle; to active stimulation of business; and finally to active stimulation of economic activity aimed at achieving carefully enumerated performance goals. The movement was from passive accommodation to active stimulation. And the responsibility for progress? No longer was the Federal Reserve alone in the center of the ring. The experiments and experience of the thirties were now signed into law. The Federal Government “with the assistance and cooperation of industry, agriculture, and labor and local governments” was to “coordinate and utilize all its plans, functions, and resources” to achieve the desired economic ends. And of course the Federal Reserve, as a creature of Congress, was bound by the Act.

Even with the passage of the Employment Act, however, the evolutionary process did not end. Time does not stand still. The framers of the Employment Act could not anticipate all the new problems that would arise. They could not foresee the whole complex of forces which would shape the postwar period. Hence, they could not

<sup>15</sup> U.S. Senate, Subcommittee of the Committee on Banking and Currency, **Full Employment Act of 1945**, 79th Congress, 1st session, hearings, July-September 1945; U.S. House Committee on Expenditures in the Executive Departments, **Full Employment Act of 1945**, 79th Congress, 1st session, hearings, September-November 1945.

<sup>16</sup> For an interesting resume of the history of and controversy over United States economic stabilization policy leading finally to the passage of the Employment Act of 1946, see Edwin G. Nourse, **Economics in the Public Service**, (New York: Harcourt, Brace and Company, 1953), pp. 49-75 and 355-367.

<sup>17</sup> **Employment Act of 1945**, Public Law 304, 79th Congress, 2nd session, February 1946, section 2.

legislate with infinite precision to provide for all eventualities.

The future was indeed to bring surprises. As a result, the idea of progress was to become even more ambitious, and we were to call for an even more careful definition and delineation of our economic goals.

Economic problems came in three waves as the nation traversed the decades of the 40's, 50's, and 60's. These waves were named inflation, growth, and balance of payments.

## THE POSTWAR PERIOD

### Inflation

First off, fears of massive unemployment and civil discord soon gave way to a grave concern over inflation. While yearly averages of unemployment never exceeded 3.9 per cent in the early postwar years, consumer prices jumped over 25 per cent between 1945 and 1949. In his mid-year Economic Report for 1948, President Truman stated:

*Repeatedly I have called attention to the developing inflationary conditions which endanger both our domestic strength and our place in world affairs . . . The policy proclaimed in the Employment Act requires us to devise and adopt positive measures to stop this inflation and secure relative stabilization.*<sup>18</sup>

Truman interpreted the "maximum purchasing power" clause of the Employment Act as a mandate to stop inflation. Others interpreted the clause only as a requirement to maintain high effective demand. But whatever the interpretation, stable prices soon became a prime goal of national economic policy. We were becoming more ambitious in our performance goals. We wanted maximum employment *and* stable prices,

<sup>18</sup> The Mid-year Economic Report of the President, July 30, 1948, pp. 1-2.

and all this within an environment of free enterprise.

During the early postwar years up until the "Accord" of 1951, the Fed was restrained in its efforts to fight inflation by its policy of supporting the prices of Government securities in order to assist the Treasury in managing the huge debt contracted during World War II. Nevertheless, the Fed realized the dangers of inflation and stressed the importance of maintaining stable prices.

But inflation was by no means to be our sole postwar problem. The world still was changing, and this change was to be reflected in our economic goals.

The next stimulus to change, however, was to come more from the *political* than the *economic* sphere. For soon the cordial relationships established with the Soviet Union during World War II gave way to developing world tension. The mental image of a kindly and benevolent Uncle Joe was replaced by the stark realism of the Iron Curtain. This changing world scene was responsible in large measure for a new emphasis on the goal of . . .

### Growth

Shortly after World War II, Soviet ambitions became more and more obvious. By external power and internal subversion the Soviets overran Poland, Hungary, Rumania, Bulgaria, East Germany, and many of the other satellites. Five years after World War II the Soviet bloc had expanded to include more than half of the land area and population of Europe. And other nations were threatened: Turkey, Greece, even powers such as France and Italy.

This nation realized that something had to be done. First, Soviet pressures were countered with aid to Greece and Turkey. Then came the

Marshall Plan, followed by a building up of military strength around the world. Finally, the fighting in Korea began.

All this took a huge commitment of men, materials, and industrial resources—so much so that an important fact was driven home. If we were to maintain our position of strength in the cold war, yet still maintain the world's highest living standard, we must produce more, improve our productivity. In a word, we had to grow at the fastest possible sustainable rate. President Eisenhower put it this way in his *Economic Report for 1954*:

*A high and sustained rate of economic growth is necessary to the welfare, if not to the survival of America and any of the free world. The United States is now engaged, and must be for some time to come, in an effort to build security forces adequate to deter and to strike back at aggression. These security-building efforts, and the parallel efforts to raise the defense potentials and the living standards of friendly peoples in other countries, are as much dependent on our industrial production as is the conduct of war itself. Success in them will depend in large part on the amount by which our national output is increased.*<sup>19</sup>

Thus we were not satisfied with mitigating swings in the business cycle, nor even with maintaining full employment. Indeed, full employment could be gained by using plows instead of tractors. We wanted full employment with *growth*, with rising per capita real income, with ever greater output per man-hour at full employment levels.

Some felt this idea was implicit in the Employment Act; others did not. But as before, implicit or not, the specific goal of growth was

incorporated into our bag of economic objectives.

Of course competition with the Soviet Union was not the *sole* reason for the emerging importance of the growth goal. Generally speaking, we must have a growing economy if we are to provide jobs for new entrants into the labor market. As time went on, this second reason for the growth goal became perhaps even more important than national defense.

In the sixties, for example, it is expected that the net addition to the labor force will be about 13 million. This is more than 50 per cent greater than the addition in the fifties.

But just as the problem of inflation was joined by the problem of growth, so growth was soon to have company. The next important problem to affect significantly our economic goals was a severe and prolonged balance-of-payments deficit.

### **Balance of payments**

The deficit in our balance of payments first became a major concern in 1958. In that year we found ourselves paying far more to foreigners for imports, investments, military and economic aid than we received for our exports of goods and services and for other transactions. The difference came to a sizable \$3.8 billion, of which \$2.3 billion was settled in gold.

Like the problem of growth, the payments deficit was related as much (and perhaps more) to political than to economic developments. Our efforts to raise the defense potentials and living standards of friendly peoples had paid off. Not only did we develop an elaborate and costly network of military installations around the world, but we “aided friendly peoples” to the extent that they became our competitors as well as our customers. We found in the latter 50’s that our international export surplus was simply not large enough to support our military and

<sup>19</sup> *Economic Report of the President*, January 28, 1954, p. 3.



economic aid expenditures abroad, plus our increasing private investments in foreign lands. The result was an alarming outflow of gold, an economic problem *par excellence*. Regaining equilibrium in our balance of payments, not a problem since the early 30's, became an important objective of economic policy.

In the December, 1963 edition of *The Federal Reserve System: Purposes and Functions*, the performance goals of the Federal Reserve System were stated as follows:

*The function of the Federal Reserve System is to foster a flow of credit and money that will facilitate orderly economic growth, a stable dollar, and long-run balance in our international payments.*<sup>20</sup>

The balance of payments had found its place as a major stated goal of Federal Reserve policy.

### IN CONCLUSION

Here, for the moment at least, the evolutionary process rests. We have reached the present.

The story of change in our performance goals has been characterized by a continual and ever more ambitious shift in the idea of progress: from passive accommodation to active stimulation, from preventing panics to encouraging a high rate of economic growth in an atmosphere of price stability and payments equilibrium.

The story of change in our environment goals, on the other hand, is characterized by a gradual shift away from *laissez-faire*. On successive occasions the old environment was found to conflict with new demands for economic performance. We found, for example, that it was difficult to maintain a reasonably stable economy without discretionary central bank action and gov-

ernmental policy to counter the business cycle.

Yet it may be that environment goals will become relatively more important. This possibility stems from the rather unique times in which we live.

The decades during which this nation concentrated on improving economic performance were characterized by a relative isolation from external pressures—from balance-of-payments problems, gold flows, and the like. That is not to say that problems did not crop up from time to time—just that we were relatively isolated. First came World War I and its aftermath during which the gold standard was abandoned by the major industrial nations of the world. Then came the Great Depression and the large gold flow into the United States which served as a sort of buffer behind which domestic policies could be pursued with little regard for gold outflows.

Then World War II was upon us and for several years thereafter, United States industrial capacity stood virtually alone. There seemed scant need to temper domestic policies for external reasons.

Then, in 1958, we realized that we had emerged from external economic isolation. This emergence was proceeding on at least two levels.

First of all, the war-devastated countries had rebuilt their productive capacity so that they could produce goods both for domestic consumption and for export. They became our competitors in world markets.

Second, Government policy was directed at an international society of nations—welded together by mutual self-interest in defense—strengthened by expanding markets, free trade and free movements of capital funds—a grand “Atlantic Alliance.”

<sup>20</sup> Board of Governors of the Federal Reserve System, *The Federal Reserve System: Purposes and Functions*, Fifth Ed., p. 1.

All this and more served to raise the curtain behind which domestic policies could be pursued with scant attention to external pressures. In effect, this nation was enlarging its environment goal. Here was culminating a longer-run movement toward free world trade which would take its place beside "free competitive enterprise." And when policies directed at such a goal begin to bear fruit, then problems of balance of payments and gold flows once more come to the fore.

Many nations through time have met external difficulties with policies which tended to depress domestic income and employment. Tight money, for example, might raise domestic interest rates and thus discourage capital outflows. But it also might discourage productive investment at home, thereby inhibiting industrial expansion and generation of new jobs.

Today, with the lessons of the thirties behind us, we are much less inclined to sacrifice domestic goals to maintain a given international environment and to achieve equilibrium in the balance of payments. Yet we recognize that the balance-of-payments problem must be solved and we realize the benefits of an international Atlantic Alliance. How, then, are we to proceed when national policies appropriate to one goal or set of goals may conflict with those appropriate to another?

Today we are reaching for a new synthesis—a means through which we may achieve both domestic and international goals without sacrificing one to the other. This synthesis is *international cooperation*—cooperation which will give us time to work out balance-of-payments problems in an environment of free trade while

pursuing policies at home appropriate to domestic conditions.

Though a tall order, much has already been done—the Federal Reserve swap arrangements are an example. Recommendations for further cooperative arrangements range all the way to the creation of a world central bank.

Undoubtedly experiments in international economic and financial cooperation will continue as times change, as the future brings unanticipated problems to an unsuspecting world. Just how fast these experiments will mature into new institutions is difficult to tell. Yet as the future unfolds, world policymakers would do well to keep in mind the words of the philosopher.

From Aristotle comes this advice:

*Let us not disregard the experience of ages; in the multitude of years, these things [new ideas], if they were good, would not have remained unknown.*<sup>21</sup>

Hegel has this word. He tells us that great men are, in essence, midwives of the future—that they anticipate the *Zeitgeist*, the spirit of the age, and pull forth its offspring.

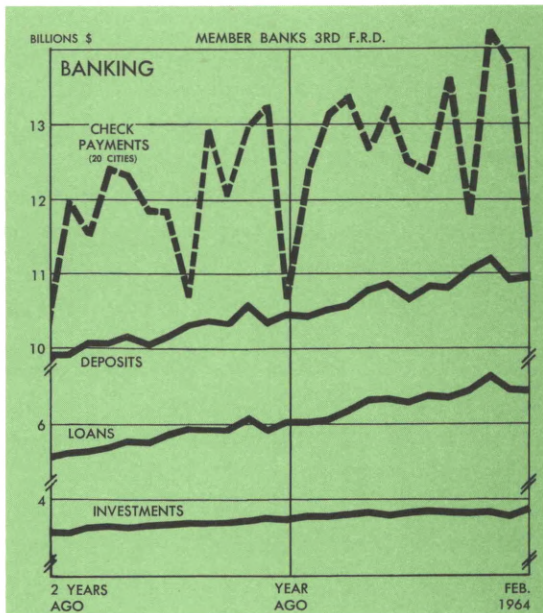
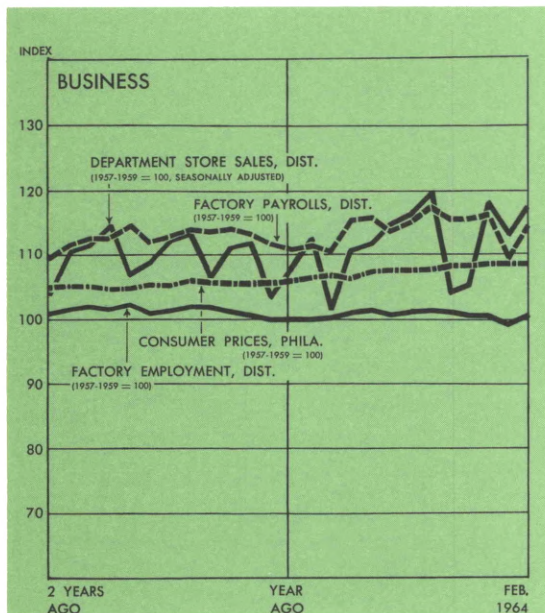
*Such individuals . . . had an insight into the requirements of the time—what is ripe for development. This was the very Truth for their age, for their world; the species next in order, so to speak, and which was already formed in the womb of time.*<sup>22</sup>

Somewhere between the experience of Aristotle and the *Zeitgeist* of Hegel lie the realities which must be dealt with in this nineteenth year of the nuclear era.

<sup>21</sup> Aristotle, *Politics*, Book II, Chapter 5, (New York: The Modern Library, 1943) p. 90.

<sup>22</sup> G. W. F. Hegel, *The Philosophy of History*, (New York: Dover Publications, Inc., 1956) p. 30.

# FOR THE RECORD...



## SUMMARY

	Third Federal Reserve District			United States		
	Per cent change			Per cent change		
	Feb. 1964 from		2 mos. 1964 from year ago	Feb. 1964 from		2 mos. 1964 from year ago
	mo. ago	year ago		mo. ago	year ago	
<b>MANUFACTURING</b>						
Production	...	...	...	+2	+7	+6
Electric power consumed	-2	+7	+7	...	...	...
Man-hours, total*	+5	-1	-4	...	...	...
Employment, total	+1	+1	0	0	+2	+2
Wage income*	+4	+3	+1	...	...	...
<b>CONSTRUCTION**</b>						
	+18	+53	+24	-4	+10	+15
<b>COAL PRODUCTION</b>						
	+9	+12	+12	-2	+3	+6
<b>TRADE***</b>						
Department store sales	+3	+7	+10	...	...	...
<b>BANKING</b>						
(All member banks)						
Deposits	0	+5	+5	0	+6	+6
Loans	-1	+7	+8	+1	+11	+11
Investments	+2	+4	+2	0	+1	0
U.S. Govt. securities	+3	-3	-6	-1	-8	-8
Other	+1	+20	+20	+1	+18	+18
Check payments	-16†	+8†	+6†	-18	+7	+9
<b>PRICES</b>						
Wholesale	0†	...	...	0	0	0
Consumer	0†	+2†	+2†	0	+1	+2

\*Production workers only.  
 \*\*Value of contracts.  
 \*\*\*Adjusted for seasonal variation.

†20 Cities  
 ‡Philadelphia

## LOCAL CHANGES

	Factory*				Department Store		Check Payments	
	Employment		Payrolls		Sales**		Check Payments	
	Per cent change Feb. 1964 from		Per cent change Feb. 1964 from		Per cent change Feb. 1964 from		Per cent change Feb. 1964 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Lehigh Valley	+1	+1	+10	+7	...	...	-17	+6
Harrisburg	+2	+3	+9	+11	...	...	-9	+3
Lancaster	+1	-1	+5	+2	+13	+17	-6	+18
Philadelphia	0	-1	+3	0	+1	+2	-13	+6
Reading	0	+2	+3	+9	0	+10	-8	+17
Scranton	+1	+3	+8	+6	+10	+10	-4	+14
Trenton	-1	+4	-1	+10	-1	+11	-35	+9
Wilkes-Barre	+4	+2	+16	+10	+12	+8	-10	+11
Wilmington	-1	+5	-4	+12	+9	+20	-34	+14
York	+3	+3	+11	+11	-2	+7	-4	+15

\*Not restricted to corporate limits of cities but covers areas of one or more counties.  
 \*\*Adjusted for seasonal variation.