

QUESTION 4.

What is the policy with respect to the volume of money?

The policy of the Federal Reserve System in this respect is to promote a gradual growth in the money supply in keeping with the growth in the monetary needs of the economy. This does not mean that the money supply must necessarily grow precisely in proportion to the growth in the total output of goods and services in this country, as changes in the rate of use or turnover of money affect the amount of money needed. That is especially true over short periods, but is also true over longer periods. The rate of use of money has been subject in the past to fairly wide fluctuations. These changes in money turnover probably reflect a variety of influences, including especially general economic conditions and the level of interest rates.

For example, in periods of depressed business conditions and extremely low interest rates, such as the 'thirties, many individuals and business concerns tend to hold idle money in preference to accepting the low rates of return or the risks of investing their funds fully. Consequently, the average rate of use of money tends to be very low and a relatively large money supply is needed to do the "money-work" of the economy. On the other hand, in boom periods, when the demands for funds are heavy and interest rates tend to be relatively high, the general tendency is for individuals and business concerns to employ their funds more fully, the average rate of turnover of money tends to increase, and the money supply need not expand proportionately with the expansion in business activity.

The latter type of situation is particularly likely to develop after a period in which the growth in the money supply has outrun the growth in the output of the country. For example, at the end of the war the increase in the

money supply had considerably outrun the growth in the gross national product, and both individuals and business concerns held substantial amounts of idle money awaiting opportunities to use it in meeting the backlog of demand for various types of goods that had accumulated during the war. A rapid increase in the rate of use of money followed during the early postwar years, and despite the comparatively small growth in the money supply (less than 9 per cent in four years), the amount of money available proved sufficient not only to finance a strong growth in physical production, but also to permit a considerable price inflation.

Because of fluctuations in the rate of use of money, therefore, it is to be expected that the money supply will frequently vary less widely from year to year than the total output of the country. In the long run, however, it is a reasonable expectation that the amount of money needed will grow roughly in proportion to the long-term growth of the economy. But even this generalization is subject to some reservations. For example, a persistent tendency toward integration in industry or toward simplification of distributive channels might reduce the number of steps by which goods pass from the production of raw materials to the delivery of finished goods to the final consumer. Such tendencies might gradually reduce the need for money in relation to the aggregate volume of production. On the other hand, increasing complexity of products and greater specialization, involving more wide-spread subcontracting, might increase gradually the volume of money transactions relative to total production, and hence the need for money.

At the opposite extreme, for periods as short as a few months, no close correspondence between changes in the money supply and changes in the volume of production or in the general economic activity is to be expected. There are fairly

regular seasonal variations in the demand for bank credit, and consequently in the money supply, which do not correspond closely to variations in aggregate production. A reduction in the money supply during the first few months of the year is usual, even in periods of rising business activity, while an increase in the money supply practically always occurs in the latter part of the year, even in periods of declining business activity. The reduction in the money supply during the first few months of 1953, which was the subject of some comment in view of the continued rise in production at that time, was illustrative of this seasonal tendency. The rate of turnover of money then was high, there was less than the usual seasonal contraction in bank loans (the reduction in the privately owned money supply at that time being attributable mainly to reduced bank investments in Government securities), and there was no evidence that the money supply was insufficient to carry on the large volume of business activity at that time.

Conclusion

For these various reasons, although it is the general policy of the Federal Reserve System to promote a growth in the money supply in keeping with the long-term growth of the economy, it is unnecessary and impracticable for the System to attempt to enforce a change in the money supply month-by-month, and year-by-year, either precisely parallel to the changes in over-all economic activity, or at a rate of growth equal to the assumed or expected long-term growth of the economy.