

MONTHLY *Business Review*

FEDERAL RESERVE BANK of CLEVELAND

April, 1957

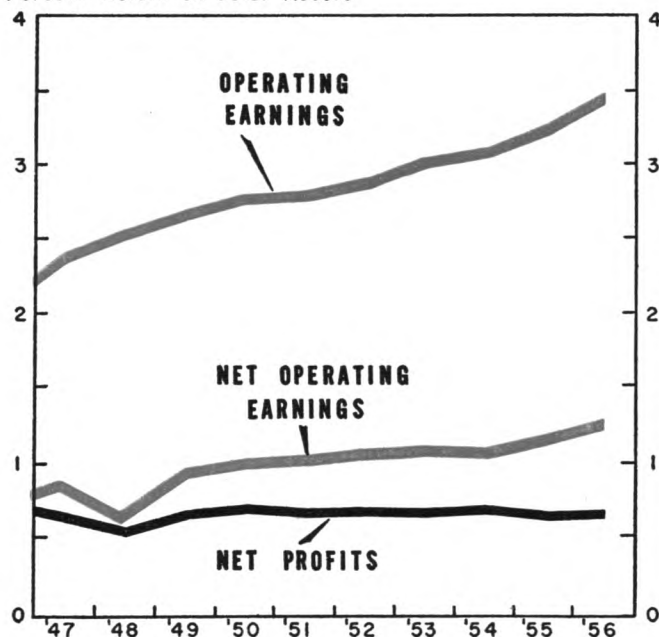
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MEMBER BANKS OPERATING RATIOS

Fourth Federal Reserve District

Percent Return on Total Assets



The rate of return on assets, as measured by the average of individual bank ratios of **OPERATING EARNINGS** to **TOTAL ASSETS**, accelerated between 1946 and 1956. However, banks did not experience a proportional gain in their "take-home pay" —ratio of **NET PROFITS** to **TOTAL ASSETS**.

Member Bank Earnings And Operating Ratios

Fourth Federal Reserve District

Part I—Earnings in 1956

EARLIER ESTIMATES of the effect of high level business prosperity on earnings and operations of Fourth District member banks¹ have been, to a great extent, supported by year-end reports of earnings and reports of condition. Such reports provide a more detailed view of member bank earnings than was previously available.

During 1956, operating earnings increased markedly, rising 14 percent or \$61 million from 1955. As shown in the accompanying table, most of the gain was attributable to a \$49-million rise in earnings from loans. Banks responded to a record demand for loans, largely from business borrowers, by shifting from security holdings to loans, which are higher yielding; average holdings of loans were increased by \$883 million during 1956 and average security holdings were reduced by \$451 million. (Averages of balance sheet items discussed in Part I are averages of figures reported on five call dates.) Both the larger volume of loans and the increase in the average rate of return contributed to the higher level of earnings.

On an average basis, the increase in business loans made up about half of the growth in loans during 1956. About 20 percent were consumer loans and 23 percent were real estate loans, the remainder being divided among other classes of borrowers. Sample

data obtained from 14 large member banks of the District indicate that manufacturers of metals and metal products accounted for roughly two-fifths of the expansion in large business loans. Public utilities accounted for about one-fifth. Sales finance companies, the largest borrowers in 1955, reduced their bank loans moderately in 1956.

Despite a reduction in holdings, securities produced an addition of \$2 million to operating earnings. The average rate of return increased from 2.11 percent to 2.37 percent on United States Government securities and from 2.26 percent to 2.35 percent on "other" securities.

The quickened pace of banking activity was also reflected in a \$10-million gain in earnings from sources not classified separately on the accompanying table. These sources of income are largely service charges on deposit accounts and other commissions and fees.

Expenses

Operating expenses rose about 12 percent, or \$30 million, in 1956, consuming about 60 percent of operating earnings. The unrelenting increase in salaries and wages made up about two-fifths of the rise in member bank operating expenses in 1956. Reflecting a larger volume of time deposits, as well as increases in rates paid, larger interest pay-

¹ See "The Year in Fourth District Banking" in the January issue of this *Review*.

MEMBER BANK EARNINGS, 1956

FOURTH DISTRICT

(Dollars in Millions)

| EARNINGS, EXPENSES, AND PROFITS | Year 1956 _p | Change from 1956 | |
|--|---------------------------|------------------|---------|
| | | Amount | Percent |
| OPERATING EARNINGS..... | \$490 | + \$61 | + 14.2% |
| U.S. Government Securities..... | 106 | + 1 | + 1.0 |
| Other Securities..... | 28 | + 1 | + 3.7 |
| Loans..... | 282 | + 49 | + 21.0 |
| Other Earnings..... | 74 | + 10 | + 15.6 |
| OPERATING EXPENSES..... | 291 | + 30 | + 11.5 |
| Salaries and Wages..... | 128 | + 12 | + 10.3 |
| Interest on Time Deposits..... | 57 | + 7 | + 14.0 |
| Other Expenses..... | 106 | + 11 | + 11.6 |
| NET OPERATING EARNINGS..... | 199 | + 32 | + 19.0 |
| NET LOSSES AND CHARGE-OFFS ¹ | — 52 | — 28 | — 116.7 |
| Securities..... | — 46 | — 26 | — 130.0 |
| Loans..... | — 3 | — 2 | — 200.0 |
| Other..... | — 3 | — 0— | — 0— |
| NET INCREASE IN VALUATION RESERVES..... | — 5 | — 0— | — 0— |
| TAXES ON NET INCOME..... | 51 | — 4 | — 7.3 |
| NET PROFITS..... | 91 | + 7 | + 8.3 |
| CASH DIVIDENDS..... | 41 | + 5 | + 13.9 |
| SELECTED ASSETS AND LIABILITIES ² | | | |
| Loans..... | \$5,799 | + \$ 883 | + 18.0% |
| U.S. Government Securities..... | 4,480 | — 451 | — 9.1 |
| Other Securities..... | 1,194 | + 1 | + 0.1 |
| Demand Deposits..... | 9,026 | + 364 | + 4.2 |
| Time Deposits..... | 4,160 | + 165 | + 4.1 |
| Total Capital Accounts..... | 1,179 | + 70 | + 6.3 |
| Total Assets..... | 14,566 | + 615 | + 4.4 |
| Total Assets Less U.S. Government Securities and Cash..... | 7,183 | + 900 | + 14.3 |
| MEMORANDUM: | Year 1956 _p | Year 1955 | |
| Ratio of Net Profits to Average Total Capital Accounts..... | 7.7% | 7.5% | |
| Average Return on Securities: | | | |
| U.S. Government..... | 2.37 | 2.11 | |
| Other..... | 2.35 | 2.26 | |
| Average Return on Loans..... | 4.86 | 4.72 | |

p Preliminary.

¹Includes recoveries credited and losses charged either to undivided profits or valuation reserves. Loss on securities is net of profits on sales of securities.

²Averages of figures reported on five call dates during year.

ments on time deposits accounted for about one-quarter of the increase in total expenses. The remainder was attributable to increases in depreciation, taxes (other than income taxes), and charges on borrowed money.

Nonoperating Charges to Profits

Net profits of member banks during the postwar period have been markedly affected by the influence of nonoperating factors on the amount of net operating earnings that was carried over to net profits. These items include recoveries and losses and charge-offs on securities, loans, and other assets; profits or losses on sales of securities; and changes in valuation reserves for securities and loans. The net effect of these factors in 1956 reduced the carry-over to net profits by \$57 million, or nearly 30 percent.

Sales of securities during 1956 to meet the expanded demand for loans entailed larger security losses than in the previous year. Net losses and charge-offs on securities, including profits on sales, amounted to \$46 million—the largest charge to profits from this source in any postwar year. Thus, the effect of rising interest rates on operating earnings was in considerable part nullified by declining security prices.

Taxes and Net Profits

More than 25 percent of the \$199 million in net operating earnings, or \$51 million, was used or accrued to pay Federal and State taxes on net income. Taxes on net income, below 1955 by \$4 million, were well above all other postwar years except 1954.

Net profits after taxes amounted to \$91 million in 1956, an 8 percent increase over 1955. That represents an increase in the return on average total capital accounts from 7.5 percent in 1955 to 7.7 percent in 1956. The increase in the rate of return was moderated by a \$70-million increase in average total capital accounts. About 45 percent of net profits, or \$41 million, was set aside for cash dividends and 55 percent retained in undivided profits.

From the viewpoint of recurring operations, the \$7-million gain in net profits in 1956 is unusual. In 1956, a decision of the Ohio Supreme Court allowed financial institutions to reduce their tax liability to the State on a capital share tax by the value of their holdings of U. S. Government securities. As a result, Ohio banks received a tax refund of about \$9 million in the form of certificates of tax abatement. The net effect for Ohio member banks was an increase in taxable income of roughly \$8 million in 1956. This tax "refund" will be largely recaptured by the State in the next three years through an increase of 3 mills on the tax rate on capital of financial institutions for the years 1957-1959.

The variety of methods of accounting used in handling the certificates of tax abatement prevents a precise analysis of the impact of this factor on net profits of Fourth District member banks. However, it seems clear that a substantial share of the \$7-million increase in net profits in 1956 flowed from this source. Otherwise, net profits were probably not markedly larger than in 1955, despite record gains in operating earnings. They were, nevertheless, as large as or larger than in any other postwar year.

Composition of Profit Growth

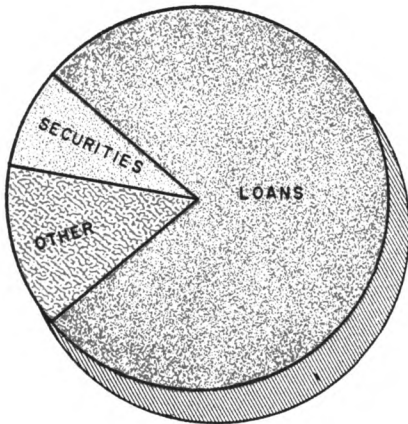
Sources of profit growth and its disposition in 1956 were, in some respects, markedly different from those of other postwar years. A comparison of the composition of profit growth in 1956 with that of the past 10 years, as shown on the accompanying chart, reveals a substantial decline in the relative importance of security earnings and a slight increase in the importance of earnings on services performed by banks. A decline in taxes on net income contributed to profit growth in four of the past ten years including 1956; nevertheless, for the entire period, taxes consumed a relatively important share of enlarged profits.

Although rising expenses have been recognized as a significant consumer of rising earnings, the impact of nonoperating factors

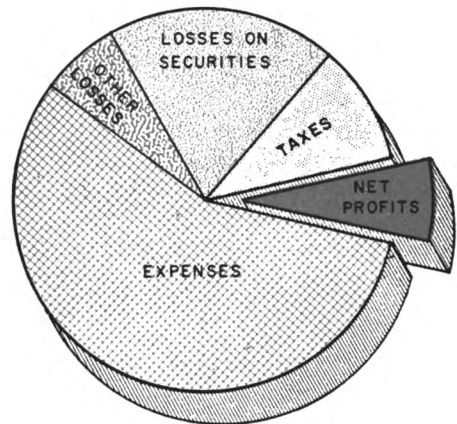
COMPOSITION OF PROFIT GROWTH

Fourth District Member Banks

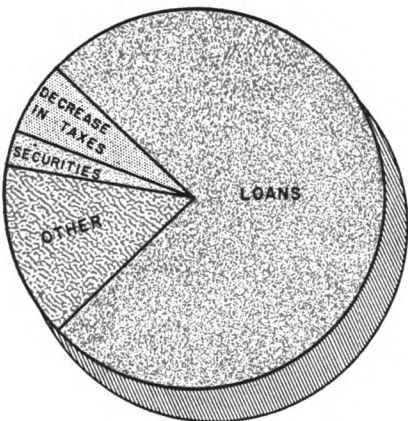
SOURCES
of Increased Earnings



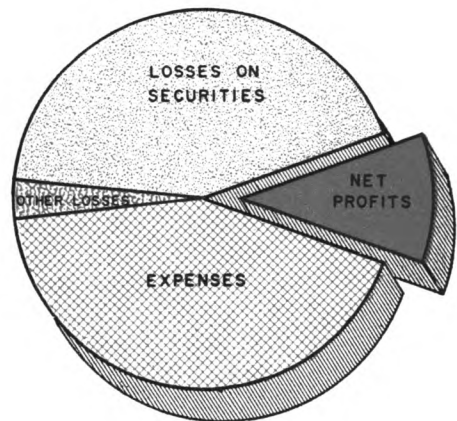
DISPOSITION
of Increased Earnings



FOR THE
TEN YEAR
PERIOD
1947 - 1956



CHANGE
BETWEEN
1955 AND 1956



is often neglected because they vary from additions to profit growth in one year to subtractions in another. In nine of the past ten years, the net effect of changes in non-operating factors has been to retard the expansion of bank profits; this effect was most evident in 1956.

Summary

Operating earnings at Fourth District member banks, swelled by increases in loans

and interest rates, reached a record level of \$490 million in 1956. However, operating expenses continued to take a large bite from earnings; net losses and charge-offs, principally from sales of securities, were more than double the year-ago level. Taxes on net income, although 7 percent below 1955, absorbed 10 percent of earnings. Thus, net profits after taxes increased little more than 8 percent; a substantial share of this gain can be attributed to a tax "refund" by the State of Ohio.

Part II—Operating Ratios, 1947-1956

Early in their history, Reserve Banks began making studies designed to provide useful data for analyzing the operations of individual banks. Methods and procedures have passed through many stages of change and improvement. Currently, each Reserve Bank publishes an annual pamphlet containing selected ratios of member bank earnings and balance sheet items. The accompanying table, containing such operating ratios for all Fourth District member banks for 1955 and 1956, reveals the comprehensive nature of these data.² For most ratios shown, comparable figures are available beginning with 1937.

Use of Operating Ratios

Operating ratios differ from ratios used in Part I in one important respect—they are averages of individual bank ratios. The purpose of averaging individual bank ratios is to reduce the impact of large banks on the final ratio. By removing the effect of size on the final ratio and providing average ratios by size and location, the individual bank can compare its operations with other similar banks.

It should be carefully noted, however, that differences between the ratios for a single bank and the average ratios indicate no more than an area subject to further analysis. Average operating ratios should not be used as a "goal" to be achieved, nor as a "standard of performance."

In addition to assisting the individual bank's internal analysis, operating ratios provide insight into the effects of changing economic and financial conditions upon member banks, without the dominating influence of a few large banks. In nearly every Federal Reserve District, there is a small number of large banks whose operations sway the district totals. When banking statistics are used for analysis of general credit and monetary conditions, it is usually desirable to retain the dominating influence of large banks found in more commonly used statistics. However, supervisory authorities must also analyze the effect of operations on the condition of smaller banks that are more numerous and that are the center of financial transactions in many areas.

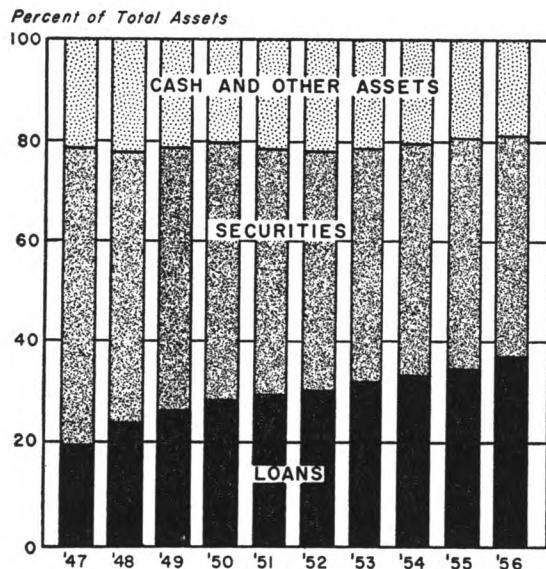
A Review of Selected Ratios

Some of the more significant operating ratios of Fourth District member banks during the past decade appear in the accompanying charts.

As shown in the cover chart, the ratio of operating earnings to average total assets increased about 45 percent between 1947 and 1956, despite a gain that more than doubled

² The table shown on page 8 does not include the breakdown by size of bank and location of bank as shown in the annual pamphlet. Copies of the latter may be obtained on request to the Examination Department, Federal Reserve Bank of Cleveland.

Asset distribution shifted from *SECURITIES* to *LOANS*.



On the other hand, large net nonoperating losses in 1952, 1953, 1955, and 1956 were partly a result of losses on sales of securities that accompanied the shift from securities to loans. Net additions to valuation reserves on loans and securities were an important source of nonoperating charges to bank earnings in four other years, 1948, 1950, 1951, and 1954. This factor, in addition to security losses, has placed nonoperating factors in the net loss column every year from 1947 through 1956. It appears from the analysis of operating ratios that more small banks have participated in the expansion of member bank valuation reserves than has generally been assumed.

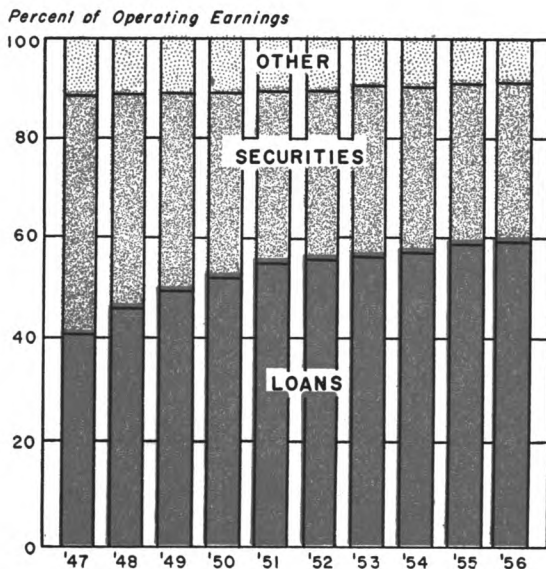
In view of the stickiness of expenses, any decline in earnings ordinarily results in a proportionately greater decline in net profits. Therefore, the expense-to-earnings ratio provides a measure of a bank's capacity to absorb declines in earnings without suffering net losses and subsequent financial difficulties. The impact of rising expenses on net profits of Fourth District member banks has been

the dollar volume of operating earnings. Thus, enlarged earnings of banks were partly a result of the expansion in assets that accompanied the postwar prosperity and partly a result of larger returns per asset dollar.

It is somewhat surprising that net profits as a percent of assets have remained steady since 1949. Despite a larger volume of business, banks have not experienced a proportional increase in their "take-home pay." Further, the size of the individual banks does not appear to be a determining factor in the inability of banks to carry over to net profits the gain in earnings.

The story of the postwar changes in member bank portfolios is retold in the accompanying charts in the perspective of ratios of securities and loans to total assets, total earnings, and net profits. Despite a substantial reduction in security holdings, securities remain a significant part of total assets and an important source of member bank earnings.

LOANS provided an increasingly larger share of *OPERATING EARNINGS*.



MEMBER BANK OPERATING RATIOS

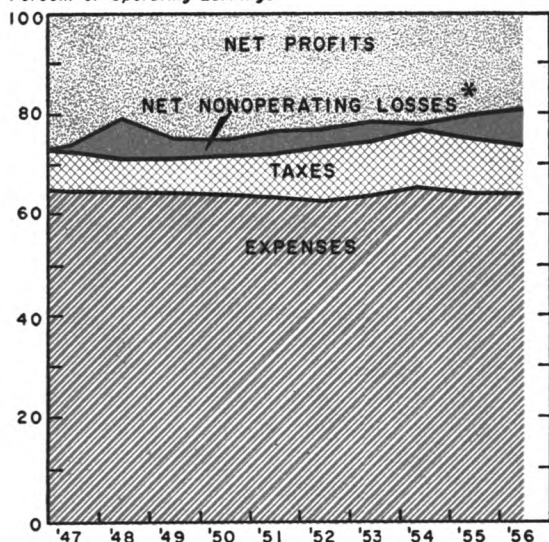
Fourth Federal Reserve District

| | 1955 | 1956 |
|---|-------|-------|
| SUMMARY RATIOS | | |
| As PERCENTAGE OF TOTAL CAPITAL ACCOUNTS | | |
| 1. Net current earnings before income taxes | 13.9% | 14.6% |
| 2. Profits before income taxes | 11.8 | 11.6 |
| 3. Net Profits | 7.6 | 7.7 |
| 4. Cash dividends declared | 2.8 | 2.8 |
| As PERCENTAGE OF TOTAL ASSETS | | |
| 5. Total earnings | 3.23 | 3.44 |
| 6. Net current earnings before income taxes | 1.16 | 1.24 |
| 7. Net profits | 0.65 | 0.66 |
| SOURCES AND DISPOSITION OF EARNINGS | | |
| As PERCENTAGE OF TOTAL EARNINGS | | |
| 8a. Interest on U.S. Government securities | 25.9 | 25.9 |
| 8b. Interest and dividends on other securities | 5.9 | 5.7 |
| 9. Earnings on loans | 58.6 | 59.0 |
| 10. All other earnings | 9.6 | 9.4 |
| 11. Total earnings | 100.0 | 100.0 |
| 12. Service charges on deposit accounts (included in item 10) | 4.8 | 4.8 |
| 13. Trust department earnings (included in item 10) | 3.9 | 3.9 |
| 14. Salaries and wages | 27.3 | 27.0 |
| 15. Interest on time and savings deposits | 14.0 | 14.6 |
| 16. All other expenses | 22.9 | 22.4 |
| 17. Total expenses | 64.2 | 64.0 |
| 18. Net current earnings before income taxes | 35.8 | 36.0 |
| 19. Net losses and charge-offs (net recoveries and profits+) | 3.0 | 4.8 |
| 19a. Net increase in valuation reserves (net decrease+) | 2.2 | 2.3 |
| 20. Taxes on net income | 10.4 | 9.5 |
| 21. Net profits | 20.2 | 19.4 |
| RATES OF RETURN ON SECURITIES AND LOANS | | |
| RETURN ON SECURITIES | | |
| 22a. Interest on U.S. Government securities | 2.18 | 2.45 |
| 22b. Interest and dividends on other securities | 2.48 | 2.56 |
| 23. Net charge-offs (net recoveries and profits+) on securities | 0.13 | 0.26 |
| RETURN ON LOANS | | |
| 24. Earnings on loans | 5.50 | 5.54 |
| 25. Net charge-offs (net recoveries+) on loans | 0.08 | 0.08 |
| DISTRIBUTION OF ASSETS | | |
| As PERCENTAGE OF TOTAL ASSETS | | |
| 26. U.S. Government securities | 37.2 | 35.3 |
| 27. Other securities | 8.3 | 8.3 |
| 28. Loans | 34.9 | 37.2 |
| 29. Cash assets | 18.6 | 18.1 |
| 30. Real estate assets | 0.9 | 1.0 |
| 31. All other assets | 0.1 | 0.1 |
| 32. Total assets | 100.0 | 100.0 |
| MISCELLANEOUS RATIOS—As PERCENTAGES | | |
| 33. Capital accounts to total assets | 8.7 | 8.9 |
| 34. Capital accounts to total assets less U.S. Govt. securities and cash assets | 20.9 | 20.2 |
| 35. Capital accounts to total deposits | 9.6 | 9.9 |
| 36. Time deposits to total deposits | 42.3 | 42.1 |
| 37. Interest on time deposits | 1.13 | 1.26 |
| Number of banks | 615 | 605 |

NOTE: For a detailed breakdown by size and by State and for definitions of items that are not self-explanatory, see Member Bank Operating Ratios, Fourth Federal Reserve District, 1956.

The share of OPERATING EARNINGS consumed by EXPENSES remained steady, while variable TAXES and NONOPERATING LOSSES trimmed the carry-over to NET PROFITS.

Percent of Operating Earnings



relatively steady; the ratio of expenses to earnings has hovered around 64 percent during the postwar years. Thus, the failure to carry over larger operating earnings to net profits must be explained by factors other than an increasing outlay for expenses. Nonoperating losses supply only part of the answer; taxes on net income, taking an increasingly larger share of earnings, supply the remainder of the answer.

Retained earnings have provided much of the capital growth of banks during the postwar era. In 1956, more than half of the net profits of Fourth District member banks was retained in undivided profits. Therefore, the effect of larger taxes and larger nonoperating losses on the carry-over from operating earnings and on the condition of member banks has been twofold: (1) profit growth has been restrained, and (2) capital growth, essential to support rising asset levels, has also been restrained.

District Steel Mills Expand Capacity

STEEL MILLS located in the Fourth District increased their steel-making capability by 2,404,000 net tons during 1956, accounting for nearly one-half of the national gain in ingot capacity during the year. The District's 5-percent expansion brought its capacity to 54,146,000 net tons at the beginning of 1957. It also boosted slightly the District's share of total U. S. capacity, raising it to 40.6 percent.

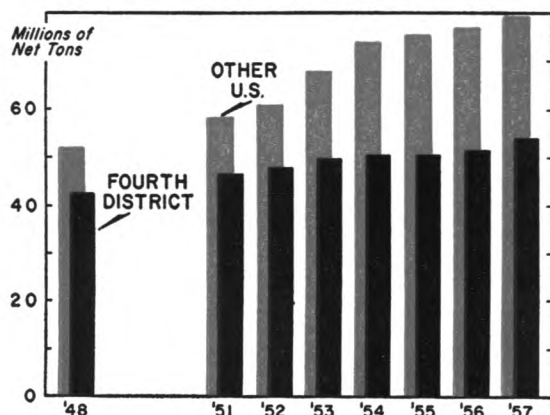
Capacity changes at mills in the Fourth District during 1956 ranged from a 434,000-ton expansion at a mill in Middletown, Ohio, to a 100,000-ton reduction at a mill in Newport, Kentucky. Additions of 200,000 tons or more were made at five other mills located, respectively, in Cleveland, Lorain, Pittsburgh, Portsmouth and Weirton.

The biggest percentage gains in steel capacity were made by mills located along the

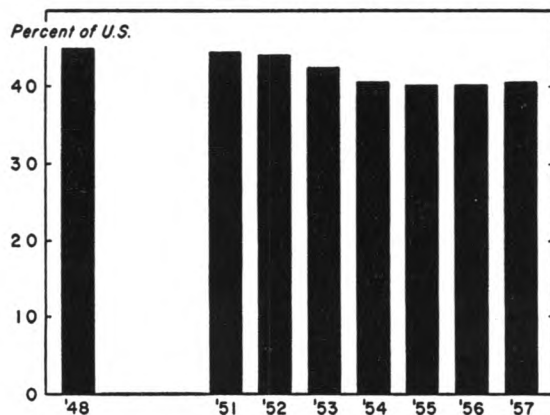
southern part of the Ohio River and in the Cleveland-Lorain area where increases of 11 percent and 9 percent, respectively, were scored. The largest tonnage increase occurred in the Mahoning Valley area where six existing mills added a total of 634,000 tons, or 4 percent, to their annual capacity and where the entrance of a new producer's open hearth in New Castle offset a reduction in capacity at a mill in Campbell. In Pittsburgh, the District's largest steel-producing area, 371,000 tons were added, raising the area's capacity 2 percent.

Expansion now under way or scheduled will increase the Fourth District's steel ingot capacity by an additional 2,500,000 tons during the next two years. By the end of 1958, Fourth District mills will have a rated annual capacity of at least 56,500,000 tons.

STEEL INGOT CAPACITY



DISTRICT SHARE OF NATION'S STEEL CAPACITY



Address of William McChesney Martin, Jr.

Chairman, Board of Governors of the Federal Reserve System

(before the Economic Club of New York, March 12, 1957)

IN INVITING ME TO ADDRESS this golden anniversary meeting of the Economic Club of New York, you are according an honor to the great American institution I am privileged to serve. It is deeply appreciated. Unless the Federal Reserve System has the interest and understanding of organizations such as yours, it cannot hope to fulfill its mission.

In seeking understanding I am not asking approval. It is not idle flattery to say that this is a highly enlightened audience, one unusually well-informed in economic affairs. Yet, I dare say, you are by no means unanimous in your feelings about that misnomer, so-called "tight money." If it gets any tighter, as one commentator has amusingly said, it may be just as hard to get into debt as it is to get out.

I shall touch on that subject later, but an occasion such as this invites a broad look at our economic heritage in order that we may take some bearings on the course we are pursuing.

One of the determinants of that course over the sweep of American history has been the position we as a nation have taken, through our democratic processes, on the role and responsibilities of the Government in economic affairs.

Fifty years ago the United States was just completing its transition from a predominantly agricultural country to the leading manufacturing and industrial nation of the world.

Jefferson's belief that Government is best when it governs least was little by little encroached upon. Yet the system we developed, with its main emphasis on the dignity of man's own initiative and enterprise, spurred the transformation of this country from a wilderness to the world's foremost industrial nation at a speed unprecedented in history.

The system worked. That was proved by the mighty surges of expansion. But progress was not smooth or painless. Prosperity came only in fits and starts. Exhilarating bursts of expansion produced in their wake depressing spells of contraction. Men began to question whether the merriment was worth the misery, especially when the misery was worst among millions who had never gotten in on the merry-making.

Early in the 20th century an event occurred to convert the public's increasingly questioning attitude into a conviction that the Government had a responsibility—a duty—to do something to protect people from economic disasters that were beyond individual control. That event was the Money Panic of 1907. It

was into that crisis that the Economic Club of New York was born and out of it that the Federal Reserve System emerged as an institutional response to public demand for the protection I cited.

Diagnosing the panic of 1907 is easy for us now. With the perfect vision of those who look backward in time, we can tonight readily perceive the panic's approach. We know now that the wave of speculative activity that preceded and provoked it was, in fact, unhealthy.

If the vision of the time was blurred, the reason lay, in part, in the widespread belief that a panic like that of 1893 or 1873 could never again occur. How could it, asked a magazine of the day, in view of the "phenomenal increase of our economic strength, the coordination of American industry since 1899, the establishment of the gold standard of currency, and, more particularly, the great and concentrated resources of our banks?"

Certainly most people were caught by surprise when the panic struck. That is evident in a picture of the time, sketched by Senator Nelson W. Aldrich in a speech to members of this club two years later. Senator Aldrich, who headed the National Monetary Commission that was established to study the causes of the financial crisis of 1907, told the members of your club, on November 29, 1909, that "to the great majority of the people of the country the blow came without warning." Most of the economic crises in our history have similarly come—which should teach us to beware of smugness or complacency.

By the time Woodrow Wilson took office as President in 1913, financial reform had become a matter of urgent priority. "It is absolutely imperative," the new President said in a special message he delivered before the Congress of June 23, 1913, "that we should give the businessmen of this country a banking and currency system by means of which they can make use of freedom of enterprise and of individual initiative . . ."

Six months later, Congress responded by passing the Act creating the Federal Reserve System, entrusting to it responsibility for managing the money supply of the country. This was a revolutionary step, signifying an end to the historic refusal of the American people to accept the very real hazards of a managed currency.

It was a careful step, too. In framing the Federal Reserve Act, great care was taken to safeguard this money management from improper interference by

either private or political interests. That is the importance of maintaining the System's independence. Hence, we have a system of regional banks headed by a coordinating board in Washington intended to have only that degree of centralized authority required to discharge a national policy effectively. This constitutes, as you know, a blending of public and private interests so uniquely American in character.

Since the Federal Reserve System came into being, the country has not suffered from inelasticity of currency and credit, from immobility of bank reserves, or from the money panics that haunted the past. However, we learned from the inflationary bubble following World War I, and the speculative collapse of the late 20's and early 30's, that elimination of these factors of instability did not prevent drastic depression. The over-all problem of stability also involves fiscal, budgetary, and debt management policies as well as prudent decisions on the part of the business and financial community.

In the sphere of business and economics, the great challenge of our times is to prevent the recurrence of the boom and crash sequence that has imperiled us in the past, and could destroy us in the future. It is a continuing challenge. Meeting it requires constant vigilance.

Over the last hundred years the American economy has experienced some 24 full turns of the business cycle, an average of one complete rise-and-fall each four years. As a general rule, the immediate impetus to expansion of the Government's role in economic affairs has come from one of these periodic disasters. But sometimes, it appears, we can be driven as hard by fear of disaster as by disaster itself. To find an example, we need go back little more than a decade, to the enactment of the Employment Act of 1946.

In that instance, so great were the psychological scars of the 1930's that the fear that mass unemployment would develop in the wake of World War II was sufficient—though the fear proved groundless—to bring about the Employment Act of 1946, pledging the Federal Government to do its utmost to keep employment, production, and purchasing power at consistently high levels.

In 1945, as all of us in this audience will recall, there was great apprehension that the problem we were going to face, when the war was over and when millions of men took off their uniforms, would be unemployment on a huge scale, and on all sides, because private business would be unequal to providing jobs for these men.

The same apprehension pervaded Congressional debate on the Employment Act in 1946. The Act was adopted almost unanimously amidst a virtual unity of opinion that it would be necessary for the Government to act to create jobs and to see that the transition from military to civilian employment would not be attended by unemployment on the scale suffered in the depression.

Actually, the history of the period since the war has made clear that the problem has not been one of creating jobs. The ingredients for growth, the technological advances, the opportunities for development in the entire Western world, in the period since the war, have been limitless—and in my judgment still are. The real problem has been sustaining jobs, and holding back inflation that would endanger those jobs by undermining stability.

Nearly everyone subscribes to the objectives of the Employment Act, but it does seem that we need to give more attention to certain related questions: What is the means of attaining high levels of employment? What is the means of sustaining jobs and leading us to a permanently higher standard of living?

In public discussion in connection with the Employment Act, you find many references to money as a medium of exchange, but almost none with respect to money as a standard of value. The reason is that almost all attention was focussed on the problem of deflation, and almost none on inflation.

In my judgment, the objectives of the Employment Act of 1946, under present conditions, can be attained only by understanding inflation and resisting it. The fight against deflation begins with the fight against inflation. If inflation is allowed to pursue its course, it feeds upon itself in such a way that, when the inevitable correction finally comes, unemployment will be that much worse.

It should not be difficult to see how inflation leads to unemployment. The danger becomes manifest when, as costs go up, it becomes increasingly hard to pass those costs along to the customer in the form of price increases, and it becomes increasingly easy to misjudge or miscalculate the market. Then, the first time volume dips there is a price-profit squeeze and, at some point, the profit squeeze leads to a cutback in investment, income and production. The cutback in production leads to a cutback in employment.

That's the cycle. It is what follows when people try to spend more than they have to obtain more goods and services than are currently available. The situation can't be cured by additions to the money supply. More money only pushes up prices, and speeds the cyclical effect.

I have less faith in the magic of money and credit than some people, and more faith in the economy than those same people when it comes to recognizing the economy's capacity for adjustment. In the last ten years we have consistently tended to underestimate the vitality and strength of our economy.

Not long ago an economic historian, Robert Heilbroner, declared that man has found, over the centuries, only three ways of insuring the execution of the thousands of intertwined tasks—the disagreeable ones as well as the pleasant ones—that must be done each day to keep human society from breaking down.

One way has been to organize society around the forces of tradition, by handing down the varied and necessary tasks from generation to generation according to custom and usage; son follows father, and a pattern is preserved. Thus, in India, until recently, certain occupations were traditionally assigned by caste.

The second way, also in use for countless centuries, has been to use the lash of central authoritarian rule to see that the necessary tasks get done. That was the system to build the pyramids of ancient Egypt. It is the system the Soviet government uses today to get its Five Year Plans carried out.

The third solution to the problem of economic survival is the market system. It achieved general acceptance only a couple of centuries ago, and yet it revolutionized civilization in the Western world.

A market provides a means of exchanging goods, but a market system does considerably more. It provides a mechanism for sustaining and maintaining an entire society. It constitutes a way of life that affords freedom that cannot exist in a society run by tradition or the rule of authority. For, in the market system, the lure of gain, not the pull of tradition nor the whip of authority, steers each man to his task. And yet, although each may go wherever he thinks fortune beckons, the interplay of one man in competition with another results in the necessary tasks of society getting done.

Now we know from our experience that the functioning of markets is not always good. Markets can, in fact, function very badly, particularly when they are dominated by monopoly, by speculative excesses, or by inflationary forces. Those of us who are truly concerned with utilizing the resources of the market must devote our energies to the promotion of competition, the restraint of speculative excess, and the maintenance of the stability of the dollar.

It seems obvious that the market system could not function without money, for money is at the heart and center of a flexible society. No modern country can have stability and progress without some basis of sound currency. That is why all modern countries have central banks. That is why the United States has the Federal Reserve System.

Money performs a great many services for mankind, but none more important than in providing a degree of freedom that man could not attain if money did not exist. The bonds of serfdom that once bound the mass of men for life to their native plot of soil and their native status in society were broken when payment in produce was supplanted by payment in cash.

Money gave men freedom of movement and leisure. It gave them the ability to change the nature and locality of their possessions and earnings at will. It gave them freedom to do as they please with the product of their labors—to eat it or drink it, to give it to a church or charity, or spend it for learning

something, to save its value against some unforeseen event, to use it to lift living standards for themselves and their families, or to put it aside to fortify their independence when they wish to assert it.

In short, money can be an instrument of freedom—if only we permit it to function in that role. But the power over money can also be an instrument of tyranny—witness the coin clipping by kings, a form of tyranny known at first hand by many of those who settled early in America. That is one of the reasons why there has been so much concern over monetary policy and monetary actions throughout our history.

When the first Bank of the United States was established under Government charter, great effort was put into preventing the Government, or political authority, from having any say over the bank and thus having a chance to indulge in coin clipping.

Gradually, as time went on, apprehension arose about too much private control over money. When the Second Bank of the United States was formed, there was some recognition that the public interest should be represented in the bank's set-up. So, the Congress made provision for public representation when it granted the bank's charter.

But to Andrew Jackson, and many others as well, it seemed that the public representation permitted was not enough. It was not that Jackson opposed the idea of any central bank, for he said in his veto message that such an institution "is in many respects convenient for the Government and useful to the people." What he objected to was that this particular bank, as it was set up, provided private interests with what was, in the words of his veto message, "a monopoly—an exclusive privilege of banking . . . granted at the expense of the public." In consequence, Jackson destroyed the bank.

The enactment of the Federal Reserve Act, as part of Woodrow Wilson's "New Freedom," marked the beginning of what we might call modern times with respect to the role of Government in monetary affairs. Jackson's complaint had been answered: there would not be private domination of money—nor political domination either.

Let us not, however, be misled into thinking that the entrustment of money management to the Federal Reserve represents a change in fundamentals or an unawareness of the economic facts of life or a denial of the ability and courage of individuals as an essential part of the mechanics by which a higher standard of living is to be achieved.

At the center of our way of life always remains the market place, tying together individual freedom and material progress. While concepts may be modified, and should be from time to time, our basic thinking continues to recognize private property, free competitive enterprise, and the wage and profit motive, operating in the open market through the price mechanism, as the most effective means of developing

and sustaining our march toward better living standards and the elimination of poverty.

Nothing in the background or history of the Federal Reserve Act indicates any misunderstanding of the law of supply and demand, or any belief that a Federal Reserve System could control or successfully manipulate, for long, supply and demand forces. Certainly the history of the past 40 years indicates the wisdom of this approach and demonstrates again that you can change the nature of demand and alter the composition of supply, but you can no more abolish the law of supply and demand than you can abolish the law of gravity. It must be reckoned with always, sooner or later, and whenever we ignore the working of the market we do it at our peril and ultimately must pay the piper.

Six years ago this month a decision to unpeg the Government securities market was in process of being carried into effect. For a number of years, efforts had been made to adjust the supply-demand relationships in Government securities without resorting to the price mechanism.

It had become quite popular in that period to assume that neither interest rates nor exchange rates made any difference, and that notions that they did matter were the fetishes of outmoded classical economists whose views were completely out of tune with the modern, postwar world. Then we saw reality creep up on us, a seller's market change to a buyer's market, and rates could no longer be pegged at artificial levels. The devaluations of the 1949 period, brought to head in September by the readjustment of the British pound sterling, were casting their shadows before and indicating that it might not be long before the supply-demand relationship in our Government securities market would have to be faced squarely unless we were willing to accept the alternative of drastic depreciation of the dollar.

Essentially, the Treasury-Federal Reserve accord returned to the market some of the influence which had been denied it by conscious Government policy for a period of more than 10 years. Once Government securities ceased to be interest-bearing money, and supply-demand relationships began to be equalized by adjustment in interest rates, the credit mechanism once again began to operate through the market place.

The Federal Reserve System ceased to be an engine of inflation. It would still be that if it were to pour out money in the endless stream that would be necessary to supply reserves in sufficient volume to meet every demand for credit without an increase in interest rates, the price of money.

No one should expect the Federal Reserve to do that, for to do so would be an abandonment of the System's duty to keep the flow of credit in line with the resources of the economy so that we may continue in the path of stability and growth. Neither should anyone fear that credit will become "unavailable at any price." Fundamentally, the so-called "tight money" situation that has evoked so much comment

has not been brought about by a reduction in the money supply. The money supply has not in fact been reduced. Actually, the money supply has increased, and so has its velocity or turnover. Credit has not been tightened by an insufficiency of money; rather, the tightening effect has been produced by the magnitude and intensity of demands for credit from practically all quarters. All of the demands could have been satisfied only by creation of more bank credit—creation of more money—and that, of course, would be inflationary.

But the problem of achieving a balance is not insoluble. In an economy as strong as ours, it can be solved in large measure by a reduction in spending and an increase in saving brought about by market forces.

The rediscovery of monetary policy in this country and throughout the free world dramatically illustrates the traditionally American recognition of the superiority of judgments arrived at in the market place to those made by individuals, or groups of individuals, within either Government or private business. It is my conviction that, by and large and excepting periods of war, you will get more impersonal, fairer distribution of our economic production through the process of the market than you will by leaving the distribution to any group of men, whether in the Federal Reserve or elsewhere. Furthermore, the workings of the market will create a greater end product to distribute than any other system as yet devised.

The background of the American Revolution is so well known that every school-boy understands, in an emotional sense if no other, the guarantees of the First Amendment to our Constitution. Freedom of religion, freedom of speech, freedom of the press, freedom of the right to assemble and petition—all of them strike answering chords in the hearts of most Americans. Yet it has also seemed to me that the inter-weaving of these concepts in the fabric of our society, in terms of livelihood, is not so well understood. That is why I have spent so much time—perhaps too much—in reviewing our economic heritage.

We are a Republic, a constitutional democracy in which the general welfare is expressed in political procedures, forms, and institutions. At the base of our structure lie certain principles and concepts, such as the market system, which are themselves the product of an evolutionary process.

In discussing these matters with you tonight, I have been motivated by conviction that the problems we are dealing with today, and the road we hope to travel tomorrow, must be related to these principles and concepts if we are to have useful guideposts by which to keep our course steady in the murk and fog that from time to time surround us.

I have a deep and an abiding faith that the foundation on which our American economy rests is firm and sure. Our American economy is, indeed, the strength of our Republic.

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