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MONEY MARKET IN NOVEMBER

Prices of long-term Treasury bonds renewed their advance during the past month reaching new peaks for the year on November 18, but in qualification of this fact is the report that trading in these securities did not have breadth nor volume. The gains of the first half of the month were lost in subsequent trading, and at the end of the month prices were at or below the October 31 levels. Apparent lack of sufficient alternative outlets for investment funds and prospects for an increased demand for long-term Treasury bonds with the growth of company pension funds and other accumulations of savings were among the factors of strength in the long-term Government bond market in the first half of the month. Price trends for highest-grade corporate and municipal bonds paralleled those of long-term Governments.

Price changes of shorter-term Treasury bonds, eligible for bank ownership, were much narrower, and yields on short-term Treasury issues fluctuated with the ebb and flow of funds in the money market. Money market conditions were somewhat erratic, and member bank reserve positions were subject to alternate periods of tightness and ease, reflecting to a substantial extent changes in the reserve positions of the New York City banks.

GOVERNMENT BOND MARKET

The advance in Treasury bond prices during the first part of November was greatest in the longest-term issues. The

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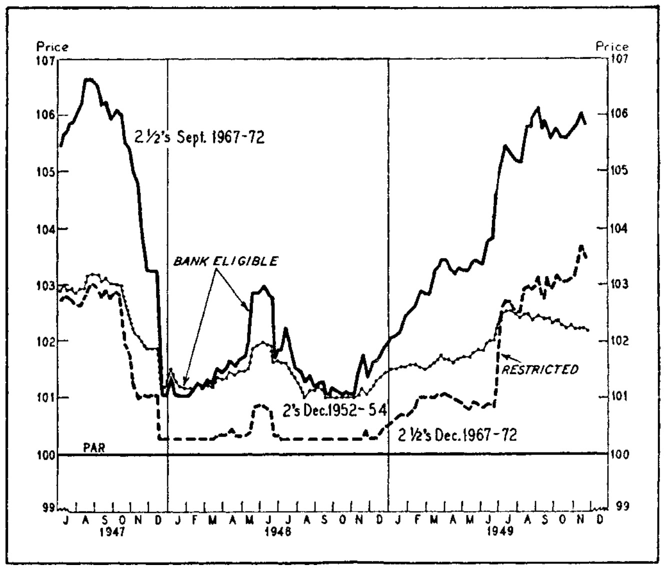
Prices of Selected Treasury Bonds*



* Averages of closing bid and asked prices, Wednesday dates; latest figures are for November 23, 1949.

possibility of higher Federal corporate taxes in 1950 probably explains the fact that the greater gains were registered by long-term partially tax-exempt bonds, the 2¾'s of 1960-65, which rose 21/32 between October 31 and November 18. In the same period, the long-term Victory bonds (December 2½'s of 1967-72) rose 20/32 of a point to the highest level since July 1946. Price movements in the longer-term eligible issues, which in the past had risen more rapidly than the ineligible issues because of their wider market and their scarcity value for banks, were more restrained. The September 2½'s of 1967-72 rose 14/32 of a point in the first 18 days of November, and were still below the levels of the summer and fall of 1947. The intermediate-term 2¼'s of 1956-59 advanced only 6/32, while the shorter-term 2's of December 1952-54 showed no change during this period. Because of investor interest in the highest-yielding Government securities, the shorter-term ineligible issues with lower yields—those which become eligible earliest—failed to move up as rapidly as the longer-term issues.

Underlying the strength in the Government bond market in the past month and in previous months has been the diminished private demand for capital, evidenced by a substantial decline in the volume of new corporate bond flotations for new capital purposes during the third quarter of this year and again in November. As a result, life insurance companies have been selling Government securities on a smaller scale than last year, and savings banks, instead of disposing of bonds to meet withdrawals of funds or to make alternative investments, have been lengthening their portfolios of Government issues. The settlements of recent labor disputes providing for pensions have caused a few trustees under pension trusts, and corporations administering their own pension systems, to shift existing holdings of Government securities into longer maturities in order to obtain the higher income needed to meet prospective obligations. Others are undoubtedly making similar preparations, and the further growth of pension plans is generally recognized as an important potential source of demand for high-grade bonds.

The supply of long-term ineligible bonds tended to diminish for a time as prices rose. Late in the month, however, a change of market sentiment led to fairly sharp reductions in Treasury bond prices. There was no evidence of large-scale selling, but the demand subsided considerably.

Inasmuch as a large part of the demand for long-term ineligible Treasury bonds during the first part of the month came from institutions and corporations which were lengthening the maturity of their portfolios rather than adding to them, a substantial volume of eligible bonds and other Treasury securities was made available to the market. This tended to restrain the advance in prices of eligible bonds, especially since the commercial banks were in a rather fully invested position most of the time and their commercial and other loans were expanding moderately.

Short-term Money Market

Money market conditions were tight in the first part of the month, through November 9. They turned easier in the following week and remained easy until the closing days of the month.

The pressure on reserve positions of the member banks in the first part of November resulted not so much from current money market transactions as from the need of individual banks (particularly the larger institutions) to overcome reserve deficiencies incurred toward the end of October. To correct these deficiencies, the larger commercial banks borrowed heavily from the Reserve Banks in the first two days of November, to bring their average reserves up to average requirements for the reserve accounting period that ended on November 2. The reported excess reserves on the last day of the period consequently rose sharply.

In the first two days of the subsequent week, banks repaid about 450 million dollars of their indebtedness to the Reserve Banks, primarily by reducing their excess reserves. Confronted with moderate net losses of funds attributable to a holiday rise in currency in circulation and other transactions during the remainder of the week, however, the banks again found it necessary to borrow from the Reserve Banks, reducing their net repayments for the entire week to 292 million dollars.

In adjusting their positions, member banks sold substantial amounts of short-term Government securities. Some of these securities were purchased by the Federal Reserve Banks, but many of them were acquired by Government security dealers who financed their purchases with loans from the banks, so that little benefit to the reserve positions of member banks as a whole resulted.

The losses of funds attributable to transactions affecting all member banks in the early part of the month were augmented, in the case of the New York City institutions, by a substantial outflow of funds to other parts of the country. The strain on the New York banks consequently was greater than on other banks. In adjusting their reserve positions to required levels, therefore, the City institutions accounted for most of the reduction of excess reserves by the banking system in the aggregate, and for most of the sales of short-term Government securities. A large part of the rise and subsequent fall in member bank borrowings from the Reserve Banks occurred at the New York City banks.

Money market conditions turned easy in the week ended November 16, owing chiefly to a sharp expansion in Federal Reserve "float" and a substantial return flow of currency from circulation. Member banks were consequently able to pay off almost 200 million dollars of their borrowings from the Reserve Banks, to purchase substantial amounts of Government securities (mainly from Government security dealers) and to increase their excess reserves by more than 200 million to 1,140 million dollars on November 16. Thus, when member banks lost moderate amounts of reserves in the following week (ended November 23), after making further purchases of Government securities, they met these losses largely by permitting excess reserves to decline to below 700 million dollars. The money market was easy during this period, and the rate on immediately available "Federal funds", after falling from 1 7/16 per cent on November 9 to 1/16-1/8 per cent on November 16, remained at comparatively low levels during the following week. The rate on new Treasury bills declined slightly from an average discount of 1.074 per cent for the issue dated November 10 to 1.056 per cent on November 17 and 1.052 per cent in the following week.

Over the three-week period ended November 23, Federal Reserve Bank loans and discounts declined more than 450 million dollars, while the System's total holdings of Government securities, mainly Treasury bills and to a lesser extent certificates, rose 136 million dollars, net. Holdings of Treasury bonds maturing in more than five years fell 23 million dollars in this period.

The need for Reserve Bank credit increased in the last week of the month, as the banks sustained moderate losses of reserve funds, chiefly as a result of an increase in currency in circulation and a moderate net excess of Treasury receipts over expenditures. A large part of the losses of reserves fell upon the New York City banks which had not only to meet the outflow of funds to other parts of the country, but also to finance substantial increases in security dealers' portfolios. Consequently the money market tightened considerably, and "Federal funds" were scarce at 1 7/16 per cent.

During the past month, foreign central banks and governments continued to convert some dollar balances held in this country into gold and to accumulate funds in their balances with the Reserve Banks. Although the devaluation of the pound sterling and other foreign currencies has not by any means been the only factor responsible for this tendency, (some change in the availability of funds through the ECA has also been cited as a factor), it presumably has been an important one. Since September 21 (shortly after the devaluation of the pound) the United States gold stock has decreased by more than 160 million dollars, while foreign deposits with the Federal Reserve Banks have increased more than 310 million dollars. A major factor in the gold outflow has been the purchase of gold from the Treasury by foreign countries to strengthen the gold backing of their currencies.

Despite the decline in United States gold holdings in the past two months, they were still 290 million dollars larger on November 23 than at the end of 1948. The rate of increase in United States holdings has declined considerably since the postwar peak rate of 2.8 billion in 1947 (before allowance for the American gold subscription to the International Monetary Fund). In 1948, the increase was 1.5 billion dollars. Increased U. S. aid to Western European and to other countries and the partial depletion of the gold and dollar reserves of a number of countries have been largely responsible for the reduction in our net receipts of gold from abroad and in the rate of spending out of foreign deposit accounts in American banks.

Member Bank Credit

The seasonal expansion of commercial loans at New York City weekly reporting member banks was interrupted in November. After reaching a peak of 4,890 million dollars on November 9 (the largest amount since early in May), business loans of the City banks declined 50 million dollars in the subsequent two weeks. This reduction does not necessarily signify the beginning of a premature seasonal decline, however, as a considerable part resulted from repayments of loans out of the proceeds of security issues. Commercial, industrial, and agricultural loans of the weekly reporting banks in other principal cities rose 110 million dollars further in the three weeks ended November 16, and remained unchanged in the following week. The business loans of all weekly reporting banks, however, were substantially below the level of the corresponding date in 1948, and in all probability 1949 will be the first calendar year since the end of the war in which business loans will have shown a net decline.

Both real estate and all other (including consumer) loans continued their slow advance, at New York City banks as well as in institutions in the 93 other reporting cities, to reach new all-time highs during the month. Despite the steady expansion of these types of credits, the gain over a year ago has not been large enough to offset the decline in business loans. Changes in security loans were large from week to week during November, reflecting chiefly Government dealer operations in the money market, and for the four weeks ended November 23 resulted in a moderate net increase.

Bank holdings of Government securities fluctuated with money market conditions, and the major changes were in holdings of short-term securities, mainly Treasury bills and to a lesser extent certificates of indebtedness. The weekly reporting banks both in New York and outside made net sales of Treasury issues during the weeks ended November 2 and 9 and added to their holdings in the weeks of November 16 and 23. However, only part of the earlier sales were subsequently made up, and the New York City banks again became net sellers during the last week of the month. Bond holdings rose moderately, mainly at banks outside New York City.

Reflecting the reductions in legal reserve requirements and in commercial loans, since a year ago, weekly reporting bank holdings of Government securities on November 16 were almost 3¾ billion dollars larger than on the corresponding date in 1948. The larger part of the increase was in the shorter-term issues, but more than 1.2 billion dollars (over 45 per cent) of the increase in total Government security holdings of the weekly reporting member banks outside New York City consisted of Treasury bonds. Net purchases of Treasury bonds accounted for less than a third of the gain in the New York City banks' holdings of Treasury issues during the year, reflecting the status of these banks as money market institutions.

CONSUMER CREDIT SINCE REGULATION W

When Regulation W and Federal control over the extension of consumer credit came to an end last June, there was considerable public discussion and speculation as to the probable results of the lifting of controls. Although only a few months have elapsed since Federal control was terminated some significant developments can already be noted. These and other recent developments in the field may be summarized as follows: First, there has been a marked, in some cases even a spectacular, liberalization of advertised credit terms. To date, however, "easy credit" is apparently still being used more as a means of drawing customers in than as a sales clincher and the actual amount of credit being extended on such terms probably is still relatively small. Second, the use of credit for the purchase of automobiles is increasing very rapidly and promises to continue to do so for some time in the future. Third, since sales of other consumers' durable goods this year to date have fallen below the levels of 1948, the dollar volume of credit extended for the purchase of such goods has also declined somewhat. There are some indications, however, that sales of these goods (and the volume of credit involved) may rise rather markedly during the last quarter of 1949. Fourth, the use of charge account credit and single-payment loans is declining. And fifth, although delinquencies and losses have been creeping up, the cautious attitude of most credit grantors is tending to keep them close to a minimum.

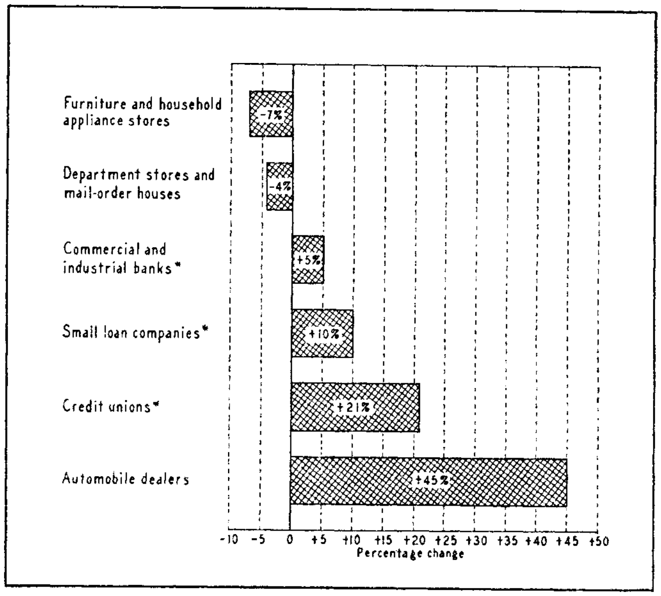
Anyone reading newspapers or other forms of local advertising media is aware that a marked liberalization in proffered instalment terms has occurred in recent months. This trend has not been as marked in the Second Federal Reserve District as in some other parts of the country, but even here advertisements have appeared for loans on the full value of a new car with 36 months to pay and for console model television sets with nothing down and two years to pay. For the first time since the mid-thirties, coin meter sales of appliances such as refrigerators, and now television sets, are occurring in considerable number. Also, instalment contracts involving "balloon" payments—a depression-born technique that was outlawed under Regulation W—are again coming into use. Under this scheme, an instalment contract calls for a large lump payment at the end which in turn is usually refinanced, in some cases even two or three times.

A closer examination of the situation, however, indicates that this relaxation of credit terms has not been as universal or as widespread as the casual observer might assume. In many sections of the country, banks and the large finance companies have tended to hold the line and have refused to take dealers' paper written on very liberal terms. Therefore, dealers have to follow fairly conservative terms on most of the paper they originate with the exception of those not too numerous distributors who are in a sufficiently strong financial position to carry their own instalment paper. Some financing is undoubtedly being done on extremely liberal terms, but to a large extent advertisements of such terms are still aimed primarily at drawing customers into a store or a lending agency. Once there, the customer is urged to make his purchase or to take a loan on more conservative terms. Furthermore, "easy" contracts are made available to choice risks only.

Within these generalizations for the country as a whole, some regional differences in the pattern have also appeared. In broad terms, credit has tended to be somewhat more liberal in the South and Southwest and least so in the Northwest. In the Second District minimum down payments for most appliances have tended to be fairly well maintained, although maturities in many cases have tended to be somewhat above average. Conditions also vary from community to community depending upon whether or not a leading store or group of stores has broken the line and the others were forced to follow along, and upon whether or not retail outlets of mail-order houses are much of a competitive factor in a given community, as two of these large chains were among the first to liberalize their terms after the end of Regulation W. For the time being, however, while available evidence indicates that the past year has witnessed a gradual lengthening in the average time that contracts written by almost all credit grantors remain outstanding, the largest volume of new instalment contracts is probably being written on terms fairly close to those prevailing just before the outbreak of the war.

From the available data, it is difficult to tell just what effect the availability of more liberal credit has had on sales volume. With the exception of automobiles, sales of most consumers'

Changes in Estimated Amounts of Consumer Instalment Credit Extended by Selected Sources
(Percentage change, Jan.-Sept., 1948 to 1949)



* Includes only direct loans; excludes repair and modernization loans.

durables and the amount of credit granted for their purchase have so far this year barely kept pace with, or have fallen behind 1948. The Department of Commerce reports that seasonally adjusted sales totals for the first nine months of 1949 were 10 per cent below the same period in 1948 for furniture and housefurnishings stores and slightly more than 1 per cent below for household appliance and radio stores (the latter might have been greater were it not for television).[1] The picture is similar if figures for the third quarter alone are compared. Possibly the availability of more liberal credit prevented a more precipitous decline in recent months. As the accompanying chart indicates, the amount of credit granted by department stores and mail-order houses during the first nine months of 1949 is estimated to have been about 4 per cent below the same months of 1948; that granted by furniture and household appliance stores was about 7 per cent below 1948. The amount of credit granted by the banks for the purchase of consumers' goods other than automobiles declined by an even greater percentage, but the total amount of credit granted by them was up somewhat as the chart indicates, owing primarily to the increase in their automobile loans. Preliminary and fragmentary evidence in the Second District indicates, however, that the use of credit for the purchase of consumers' goods other than automobiles may show a rather pronounced rise in the final quarter of 1949.

As has been indicated, the use of credit for the purchase of automobiles rose very sharply during 1949. Judging from recent surveys of consumer financial positions and buying intentions, and barring any unforeseen change in economic conditions, automobile credit sales may continue at a high level for some time to come. Credit extended by automobile dealers, as the chart shows, was 45 per cent greater during the first nine months of 1949 than in the same period of 1948. The amount of automobile credit extended directly by commercial and industrial banks rose about 13 per cent. At the end of September automobile sale credit outstanding accounted for approximately 17 per cent of the total amount of consumer credit in use compared with 12 per cent in September 1948. In September 1941, however, when it reached its prewar peak, automobile sale credit represented 22 per cent of total volume of consumer credit outstanding.

The use of noninstalment types of consumer credit also has tended to decline in recent months, as the accompanying table indicates. At the end of September charge accounts were 731 million dollars below the level at the end of December 1948. Charge account receivables would normally be expected to be lower this time of year than in December which is the seasonal peak, but during the first nine months of 1948 the net decline was only 385 million dollars. Also, the average number of days that charge accounts remain outstanding has been declining slightly in recent months. Single-payment loans, which showed a minor increase of about 148 million during the first three quarters of 1948, declined approximately 87 million during the same period this year. Service credit, however, has continued to show small increases. While losses and delinquencies have been creeping up, there is no evidence as yet of any sharp or alarming rise.

[1] Some part of these declines may reflect a decrease in prices.

Changes in Amounts of Consumer Credit Outstanding by Type
(Dollar amounts in millions)

Type of credit	Change during first nine months			
	Dollar volume		Percentage	
	1948	1949	1948	1949
Total instalment credit	+1,756	+1,288	+27	+15
Automobile sale credit	+ 707	+ 922	+61	+47
Other sale credit	+ 400	− 3	+21	*
Cash loans	+ 649	+ 369	+19	+ 9
Total noninstalment credit	− 198	− 803	− 3	−10
Charge accounts	− 385	− 731	−11	−19
Single-payment loans	+ 148	− 87	+ 5	− 3
Service credit	+ 39	+ 15	+ 4	+ 2

* Less than 0.5 per cent.

DEMAND FOR CASH DURING HOLIDAY PERIODS

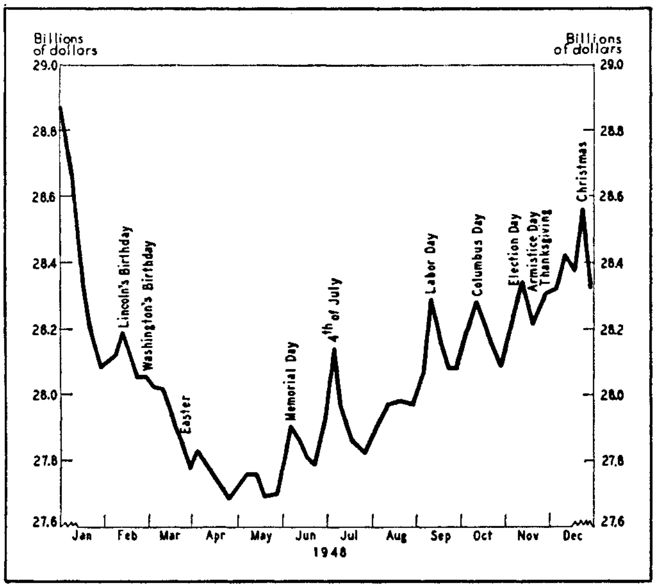
Changes in the amount of currency in circulation are one of the more important factors affecting short-run fluctuations in member bank reserves and in the need for Federal Reserve credit. Major periodic flows of money into and out of circulation are caused by holidays, when the demand of the public for currency fluctuates widely within a short period of time.

For a week or more before each major holiday (several weeks in the case of Christmas), the amount of money in circulation increases very substantially, and after the holiday it declines correspondingly, except in the case of Thanksgiving when the decline is concealed in the pre-Christmas increase. In some cases, these preholiday outflows and subsequent return flows of currency may amount to well over 200 million dollars. Unless offset by action by the Federal Reserve System, they affect, for a limited period of time, conditions in the money market. In this article, the influence of currency flows originated by holidays upon member bank reserves is reviewed and some tentative estimates of the magnitude of the movements are presented.

Money in circulation, defined as all money outside of the Federal Reserve Banks and the Treasury, includes currency in the hands of the general public as well as in the vaults of banks. At all times, the amount of money in circulation is ultimately determined by the demands of the public. It varies constantly in response to the changing requirements for currency on the part of individuals and businesses.[1]

[1] Currency may also be used at certain times as a store of value (i.e., hoarded), but generally this use does not affect to any considerable extent short-term changes in the amount of money in circulation.

Currency in Circulation*
(December 31, 1947-December 29, 1948)



* Outside U. S. Treasury and Federal Reserve Banks; Wednesday dates.

Currency (including coin) is used by the public mainly for the smaller current transactions commonly carried on in cash, such as most types of retail purchases and various minor expenditures of individuals. Also, a large part of payrolls is paid out in currency. As more currency is required for these purposes, the public (including business establishments) makes withdrawals of deposits at the commercial banks; as the needs are reduced, currency is redeposited. Banks usually keep in their vaults only enough cash to insure that an adequate supply is on hand to meet the needs of their customers. As a period of increased need for currency approaches, and until it ends, the banks may add temporarily to their vault cash. Vault cash, therefore, tends to fluctuate in close relation with the public's demand for cash.

Both the amount and the fluctuations of vault cash are relatively small compared with total money in circulation and its movements. Since vault cash is not an earning asset and does not count as reserves for member banks, most commercial banks probably deposit promptly all surplus currency they receive with the Reserve Banks (or with a correspondent bank, which in turn deposits its excess receipts with a Reserve Bank) in order to gain reserves or to reduce borrowings. Conversely, they withdraw currency at the expense of their reserves (which they may need to restore by borrowing at the Reserve Banks) only in anticipation of an increased demand from the public. Thus, the large increases in the requirements for currency on the part of the public before each holiday reduce member bank reserves and raise the amount of money in circulation, while the reduced demand for money after the holidays causes a return flow of currency to the Reserve Banks and tends to ease the money market.

A number of factors contribute to the increased needs for currency before a holiday. Individuals may require more cash on the average for pocket money to cover travel expenses, purchases of gifts and special foods, and expenditures for entertainment or for similar purposes. Certain holidays, notably Christmas, are preceded by gift shopping periods of several weeks' duration. Also, some businesses, especially those catering to the holiday trade, may need an increased amount of till money and payroll money. In the case of bank holidays which are not generally observed by the business community, additional currency may be withdrawn in order to insure a sufficient supply for normal expenditures while the banks are closed.

The amount of currency that the public requires for any particular holiday depends on a number of factors. Some holidays are traditionally spent at home, others away from home. Also, some holidays are nationwide—as the major religious holidays—while others are observed in certain parts of the country only.

The holiday demand for currency is superimposed on the distinct patterns of currency demand which already exist between months of the year, within the month, and also within the week. On a monthly basis, currency tends seasonally to return from circulation in January particularly, and to some extent during the first third of the year. Thereafter, the amount of currency in circulation ordinarily fluctuates without a sustained change of level until the last five months of the year, when the general trend is upward. The pattern within the month is characterized by an outflow of money into circulation of considerable proportions during the last week of each month and the first several days of the following month and a return flow in the remainder. The end-of-month outflow of currency is larger in some months than in others and it does not always appear at precisely the same time. It is, therefore, difficult to distinguish exactly between the month-end and holiday influences in many instances where holidays fall near the end of a month (July 4, Memorial Day, Labor Day, Thanksgiving, and Christmas). As for the weekly pattern, there are regularly rather large intraweekly changes in the amount of money in circulation, and these movements may alter any estimates of the magnitude of the holiday influence. The following estimates presented are based on the average experience of recent years.

Among all legal holidays, Christmas has the most pronounced influence on the amount of money in circulation. Because its effect really begins with the start of the Christmas shopping season several weeks before the holiday, the total effect of the holiday upon the amount of money in circulation cannot be evaluated with any considerable degree of reliability. There is, however, a very distinct movement beginning almost two weeks before Christmas that may be directly attributed to the influence of the holiday, and during this period between 200 and 275 million dollars are drawn into circulation.[2] Large purchases of gifts, greatly increased travel expenditures, expanded purchases of food and delicacies, gifts of money, and other holiday expenses, are reflected in this outflow. Immediately after Christmas the need of the public for money is rapidly reduced, and currency quickly returns to the Reserve Banks. This return flow takes place despite the fact that there is normally a large outflow at the end of each month. The only indication of this normal month-end movement in December is a somewhat slackened rate of return around the beginning of January.

In terms of its effect upon the circulation of currency, Independence Day ranks next to Christmas. The influence of this day, traditionally the beginning of the summer vacation period, is sometimes felt as much as ten business days in advance. While it is unlikely that individuals or businesses have begun net withdrawals of currency at that time, the banks increase their vault cash in anticipation of the demands of the public to come several days later. Even after making allowance for the normal month-end movement, which takes place at about the same time, it is probable that Independence Day adds about 150 to 200 million dollars to the amount of money in circulation. The extra amounts of currency are used largely for travel and vacation expenses by individuals and in resort businesses. The return flow takes place from one to three business days after the holiday; the beginning of the period of the return flow is later when the holiday falls at a week end.

Less important than these two holidays is Thanksgiving, which produces an outflow of currency of 100 to 150 million dollars more than normal for that period of the month. However, the influence is rather short lived, and is probably attributable almost entirely to travel expenses and extra food purchases. It is first felt six or seven days before the holiday but there is no (or very little) return flow afterwards, because a large amount of currency is retained by the public (or the banks) for month-end needs, and Christmas shopping is already under way.

The influence of Labor Day may be substantial, in some years at least, but it is very difficult to estimate because from year to year this holiday falls on different days of the month. It is probable that the effect of Labor Day is considerably less than usual when the holiday falls within the first few days of the month. The normal month-end outflow at that time may suffice, at least in large part, to cover holiday needs. However, when the holiday falls a little later in the month (on the fifth to the seventh), there may be a Labor Day outflow amounting to well over 100 million dollars.

The evidence regarding the influence on currency movements of the Lincoln and Washington birthday holidays is not conclusive, since there are a number of factors tending to obscure what influence may be present. These two holidays are less important than others in terms of travel expenditures and gift and food purchases. In addition, they are only about nine business days apart, so that their influences overlap; moreover, Lincoln's Birthday is not observed generally throughout the country. Finally, the influence of the February 12 and February 22 holidays is further obscured by the fact that there is a strong seasonal tendency for currency to return from circulation both during the middle of each month and for several months after Christmas.

Other holidays have considerably less influence on the volume of money in circulation. Memorial Day, Columbus Day, and Armistice Day and Election Day combined are of roughly equal importance. They each increase money in circulation by approximately 75 to 130 million dollars; Armistice Day (together with Election Day) ordinarily is the most important of the three and Memorial Day the least important. The effects of each of the three holiday periods may be first noted six or seven days before the holiday, and the return flow begins one or two days after the holiday and continues for about a week. The effect of Easter upon the amount of money in circulation is apparently minor and it is also very difficult to determine, because of the shifting date of this holiday.

Holidays other than those mentioned may affect currency flows in certain sections of the country, but their influence is not discernible on a national scale. It may be concluded, however, that all the major holidays, and especially Christmas and Independence Day, require a considerable amount of currency in excess of normal needs which is supplied by the Federal Reserve System without disturbing the money market.

THE ECONOMIC RECONSTRUCTION OF JAPAN

The current speculation about an early conclusion of a peace treaty with Japan has focused attention upon the political and economic problems of that country. This article seeks to assess recent developments in the economic field.

By August 1949 the output of Japanese manufacturing and mining had so far recovered from the effects of the war that it had reached 136 per cent above the 1946 average. Nothwithstanding this improvement, it was still only 78 per cent of the average rate for 1932-36, the period immediately prior to the "China Incident," and one when the pattern of industry was roughly similar to that which will probably prevail during the next few years. Price levels during the same time rose very sharply. The index of official wholesale prices for August 1949

[2] This and the following estimates are based on the experience of recent years. During the war these patterns were submerged in other wartime developments. The magnitudes involved in prewar years were, of course, much smaller.

was 10½ times higher than in August 1946,[1] while the cost of living index, based on expenditures in both official and black markets, was 4 times higher. The average monthly wage in manufacturing industries, it is true, was 13 times greater than three years earlier, implying some improvement in wages measured in terms of actual purchasing power, but government estimates indicate that the latter were still less than half those of the mid-thirties.

The major hindrance to the restoration of the prewar level of production has been the loss of Manchuria, Korea, Formosa, and the other colonial territories that previously provided resource-poor Japan with the larger portion of her foodstuffs and industrial raw materials. To fill the strangling import vacuum resulting from the dismemberment of the empire, the United States has financed more than two thirds of Japan's postwar imports, to a total of more than 1.5 billion dollars. During the first three years of the occupation, half of these imports, provided under the "prevention of disease and unrest" occupation formula, consisted of foodstuffs alone. In 1949, however, the United States Government decided to give Japan more basic assistance in order to permit more rapid reconstruction of her economy, with the result that since July the amount of American-financed imports devoted to relief types of supplies has been declining, and a growing proportion has consisted of raw cotton, petroleum, fertilizers, and other producers' goods.

Total exports have increased steadily from the very low levels prevailing immediately after the war, rising from 103 million dollars in 1946[2] to an annual rate of 558 million during the first seven months of 1949. At the same time the annual trade deficit has also grown, albeit less rapidly, expanding from 202 million dollars to an annual rate of 428 million for January-July 1949; the proportion of imports not covered by exports has declined from 66 per cent to 40 per cent. Notwithstanding this improvement, Japan still has far to go before she will regain her 1932-36 position when the volume of average annual trade was roughly 150 per cent more than now, and the imports not covered by exports amounted to less than 4 per cent.

Half of Japan's postwar exports through 1948 consisted of textiles, the production of which had been fostered by the occupation authorities through the importation of large quantities of raw cotton. Raw silk exports were next in importance, contributing another 17 per cent. During the current year, however, although the volume of textile and fiber exports has continued to rise, their percentage has diminished, while exports of machinery and metal products have gained in prominence.

Although in the financial sphere of the Japanese economy there has not been the progress which with American assistance has been made in physical output and foreign trade, signal improvement has occurred during 1949. The tremendous upward surge in prices that marked 1945 to 1948 was a consequence of inefficient enforcement of direct controls and of inflationary monetary and fiscal policies. This rise, however, was largely checked in 1949.

On September 30, 1949 the national debt stood at 521.5 billion yen, 3½ times the March 1946 level, and 22 times that of March 1940. The September figure, however, represents a 5 per cent decline from the December 1948 peak, and although the usual seasonal year-end expansion will probably push the total close to the December 1948 high mark, the avoidance of a rise for a whole year will have been a distinct achievement. Similarly, the past year has witnessed some improvement, although small, in the distribution of the debt. At the end of September 1949 the Bank of Japan still held 46 per cent of the total debt, while the ordinary commercial banks and the nonbank investors held only 20 per cent (as against 7 per cent and 58 per cent, respectively, in March 1946), but the Bank of Japan's holdings represented a 10 per cent contraction from September 1948. The funded share of the debt was only 54 per cent, compared with 70 per cent in March 1946 and 97 per cent in March 1940.

The trend in the money supply is still upward, although here too the rise has slackened, with the result that during the first seven months of 1949 the money supply expanded by less than one seventh, whereas during the corresponding period of 1948 the increase was about one third. Moreover, the entire rise was confined to bank deposits, with the note issue declining from 355 billion yen to 296 billion. These changes have somewhat improved the composition of the money supply, although the ratio of notes to bank deposits was still 1 to 2 compared with the 1932-36 ratio of about 1 to 6.

The improvements that have been noted in the financial sphere have stemmed in large part from the so-called Dodge reforms introduced this spring when Mr. Joseph Dodge, Detroit banker and former finance division chief of the American Military Government in Germany, was acting as advisor to SCAP in Japan. The reforms included a balanced budget with reduced government expenditures and increased taxes, as well as credit restrictions, a single exchange rate, and the elimination of export subsidies and the curtailment of domestic subsidies. While putting a much-needed brake upon the inflation, these measures have understandably had a temporarily adverse effect upon production. Thus, after the index of industrial production had risen 11 points from January to April 1949, thereby reaching 79 per cent of the 1932-36 level, it

[1] The wholesale price index based on both official and black market prices recorded a less drastic threefold increase, reflecting the relatively more acute increase in black market prices during 1946, and their drop during 1949.

[2] Including a small amount for the last four months of 1945.

ceased to advance and by the end of August had actually dropped one point. From April to August of the previous year production had risen 9 points.

Although figures are not yet available, reports indicate that the industrial readjustments had been largely accomplished by September. The easier atmosphere that resulted was reinforced by the publication of the tax reforms worked out by a mission headed by Professor Carl Shoup of Columbia University. Despite criticism from some sources, the general reaction of industrial leaders was one of approval and optimism, particularly because of the lightened tax burdens advocated for business and the high-income groups, and the inclusion of a long-awaited program for the revaluation of business assets.

But in the middle of September industry received a new blow from the sterling and other currency devaluations. These meant a twofold obstacle to Japan's exports, since not only did her leading competitor, the United Kingdom, devalue, but so also did most of her important export markets. Almost one half of total Japanese exports in 1948 had gone to the devaluing countries—77 per cent in the form of textiles—but only 10 per cent of her imports came from those areas. The net effect of the devaluations upon both the terms of trade and the balance of trade of Japan is therefore likely to be unfavorable.

Although SCAP has declared that the exchange value of the yen will not be lowered, probably in the belief that to do so would make internal stabilization more difficult, it has permitted the abolishment of the floor prices on exports,[3] a strategic step that should help to regain for Japan a good part of the competitive position lost when sterling was devalued. The outlook is particularly good for cotton goods, thus far the most important postwar export; the production of cotton textiles has been very profitable since the establishment in April of the single exchange rate of 360 yen to the dollar, and the removal of floor prices should result in quotations competitive with those of the United Kingdom.

Despite the financial improvement in 1949, and the good prospects for renewed progress in production and exports, Japan's economic future remains very uncertain. To live Japan must trade. She has lacked sufficient foodstuffs and raw materials since she became an industrialized nation. The sudden expansion of her population from 72 million at the end of the war to 82 million in 1949,[4] has greatly increased the pressure on her resources. Having lost her empire, she will not easily regain the standard of living recommended as a goal by the Far Eastern Commission—that of 1930-34, a time when the population was only about 67 million. The cessation of the reparations program has left Japan with a more valuable industrial base than she possessed in 1930-34, which will indeed help. But if American aid, which is scheduled to provide the major part of her 1949 imports, were to be suddenly cut off, Japan would find herself in dire straits. A great expansion in exports, a reorientation of her trade towards Asia and Africa (where, however, political and economic instability will be an impediment), and the attracting of foreign loans, are now her most important and difficult tasks.

[3] Floor prices on silk products, however, will not be removed until the end of the year.

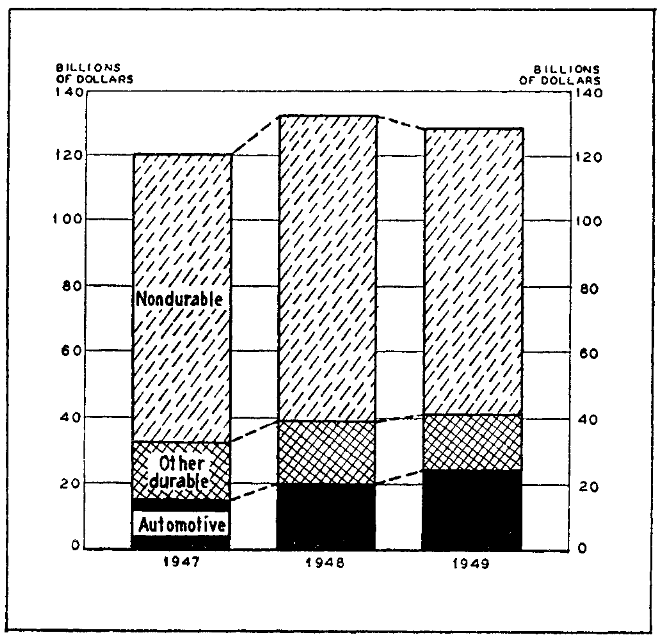
[4] It is estimated that ten years hence her population will reach 95 million.

DURABLE GOODS SALES AND RETAIL TRADE

One of the most significant factors in the readjustment period which began in the latter part of 1948 has been the relative stability of retail sales, even during the period of rising unemployment, declining payrolls, and curtailed production. From the all-time record set in August 1948 to the low point reached in July 1949, the seasonally adjusted dollar volume of retail sales (as measured by the U. S. Department of Commerce's recently revised estimates of retail sales) declined less than 5 per cent, approximately by the same percentage as retail prices of all commodities. During the first ten months of this year, customers spent at all retail establishments only about 1 per cent less than in the corresponding period last year, while retail prices averaged 2 per cent lower.

This stability in the aggregate volume of retail purchases was the result of a continued high level of expenditures for durable goods. In fact, it was almost entirely attributable to the rising sales of automobiles, since sales of other durable

Total Retail Store Sales—Durable and Nondurable Goods
(Third quarter 1947, 1948, and 1949; seasonally adjusted annual rate)



Source: U. S. Department of Commerce.

goods on the whole have been tapering off during the past year. Sales of homefurnishings (including household appliances), jewelry, and building materials stores have all been below last year's levels. In the third quarter of 1949, sales of these three types of stores were running at an annual rate which was about 2.4 billion dollars below the third quarter of last year and even somewhat lower than the corresponding period of 1947. Sales of the automotive group, on the other hand, rose by about one fifth, or at an annual rate about 4.3 billion dollars above the third quarter of 1948, and nearly 60 per cent above the same quarter of 1947. The sustaining influence of automobile sales has been so great that August, September, and October of this year were the three highest months on record for aggregate seasonally adjusted sales of durable goods stores.

In the nondurable goods category, consumer expenditures in food stores remained fairly stable despite somewhat lower prices, and filling station sales have been well maintained. However, the sales volume of other nondurable goods stores has been declining and in the third quarter of 1949 was 9 per cent below the same period in 1948, a drop of about 5 billion dollars at an annual rate. One of the sharpest declines occurred in the apparel group where sales were down 12 per cent. Department store and mail-order house sales—often used as an indicator of retail sales in general—showed a decline of 10 per cent between the third quarters of 1948 and 1949. The discrepancy between this and the 3 per cent decline actually registered in sales of all retail stores arises primarily from the fact that department stores sell a negligible proportion of items —food, gasoline, and automobiles—whose sales have been stable or rising.

How long passenger car sales will be able to continue to offset the reduced volume of business in other lines is a question that is attracting considerable discussion. Already there are some indications that automobile sales may have reached their postwar peak. From August through October, seasonally adjusted sales of the automotive group leveled off, and—what may be even more significant—retail stocks of this group of dealers rose sharply. Nevertheless, even if the extraordinarily high current rate of automobile sales should not be fully maintained, a continued substantial level of replacement sales is in prospect. Earlier this year, the U. S. Department of Commerce estimated that the wartime deficit in automobile production had nearly been made up and the over-all number of passenger cars was approximately in line with current levels of population and income. At the same time, however, the Department pointed out that in mid-1948, about 6 million passenger cars, or close to one fifth of the total, were already past the estimated postwar scrappage age (12 years) and were due for replacement, while nearly one third of the cars on the road were past the prewar scrappage age (10 years). A Federal Reserve survey,[1] made in July 1949, showed that the number of consumers planning to purchase automobiles during the coming year was still at an extremely high level. Similarly, the demand for home appliances, furniture, farm equipment, and building materials may have receded somewhat from its postwar peak, but is expected to be sustained in the next few years by the large need for replacements. In addition, an expanding market for some of these items is provided by the high rate of residential construction, which in 1949 is expected to break all previous records by providing nearly a million new homes, and probably at least 900,000 more in 1950, according to official estimates. The accelerated sale and replacement of consumers' durable goods in the past few years, however, may well have repercussions later, since the proportion of households owning relatively new automobiles and appliances will then be much larger and the demand for replacements commensurately smaller.

Another factor which has stimulated sales of durable goods more than those of nondurable goods is the ready availability of credit, as evidenced by the rapid rise in consumer instalment debt discussed elsewhere in this issue. Since the expiration of Federal Reserve consumer credit controls at the end of June, there have been some attempts, particularly among appliance and radio dealers, to boost lagging sales by competitive loosening of credit terms. The announcement that 2.8 billion dollars in Government insurance dividends will be distributed to veterans early next year may already be having some effect on sales, particularly of durable goods, because of anticipatory spending. It is likely, however, that some portion of these payments will be saved, invested, or applied to the repayment of debts. (The Federal Reserve Survey of Consumer Finances reported that about three tenths of the veterans cashing terminal leave bonds in 1947 used them for such purposes, while about two fifths of those receiving bonds had not yet cashed them at the time of the survey in early 1948.) Hence, the impact on retail sales may not be as strong as might be anticipated in view of the total amounts to be distributed, particularly if payments are spread over a period of several months.

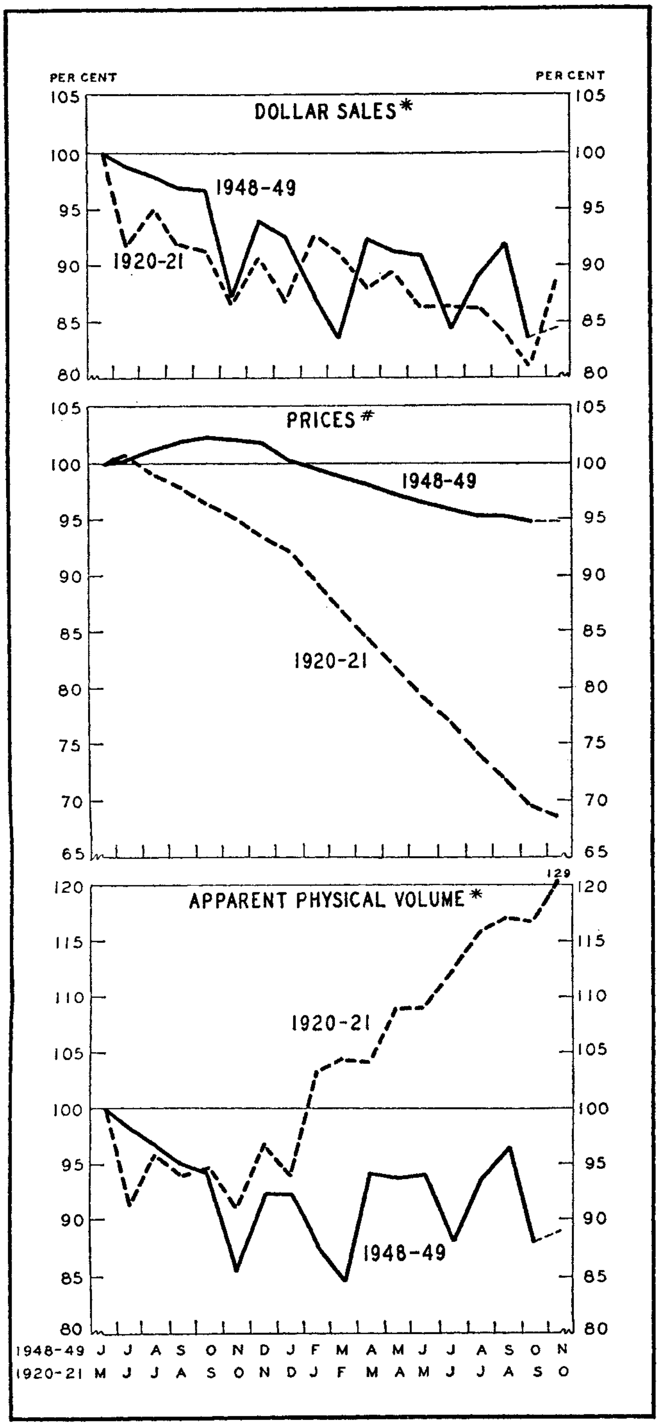
[1] Survey made for the Board of Governors of the Federal Reserve System by the Survey Research Center of the University of Michigan. (See October 1949 *Federal Reserve Bulletin.*)

DEPARTMENT STORE TRADE SINCE THE END OF THE WAR

Sales at Second District department stores during November expanded somewhat more than seasonally, indicating a small rise in seasonally adjusted sales above the low level of October, according to a preliminary estimate. The year-to-year decline, about 3 per cent, was the smallest since April, partly because business in November 1948 had been conspicuously slow. Sales compared most favorably with those of the corresponding period of last year during the last calendar week of the

Indexes of Department Store Sales and Prices Second Federal Reserve District

(May 1920 and June 1948, respective postwar dollar sales peaks,=100 per cent)



* Adjusted for seasonal variation; November 1949 estimated.

\# Weighted average of clothing (2) and housefurnishings (1)—subgroups of Bureau of Labor Statistics' index of consumers' prices. November 1949 estimated by Federal Reserve Bank of New York. For 1920-21, monthly figures were interpolated between semiannual data.

month. The cold snap that developed towards the end of November this year was apparently an important influence.

The Postwar Readjustment in Sales

By the end of November, sixteen months had elapsed since the dollar amount of sales in this District's department stores began to recede from the all-time record level (on a seasonally adjusted basis) of June 1948. This bank's index of sales declined in this period from 262 per cent of the 1935-39 average to 221, indicating a loss of 16 per cent in the daily rate of dollar transactions. The most reliable information at hand suggests that during this period prices of department store merchandise had been reduced by only about 5 per cent. The much greater drop in dollar volume could only have stemmed from a diminished flow of merchandise, apparently amounting to about 11 per cent.

The readjustment in the dollar volume of sales through November has a striking resemblance to the readjustment of 1920-21 after World War I. Changes in the estimated physical volume of goods sold, however, reveal striking differences. The very severe price cuts, which characterized the 1920-21 business realignment, apparently were accompanied, after a brief "shakedown," by a rapidly rising volume of actual merchandise moved in the face of declining dollar volume, as illustrated in the accompanying chart. While in September 1921, after having tended downward for sixteen months, seasonally adjusted dollar sales were 19 per cent below the May 1920 peak, estimated physical sales volume had increased by some 17 per cent. Dollar sales turned upward in the following month and in the subsequent period of relatively stable prices, units of goods sold continued the upward trend initiated many months before.

Owing to difficulties in securing adequate price statistics for estimating physical volume from dollar sales, the contours shown in the chart and the percentage changes computed (other than dollar sales) from the same basic data must be interpreted as rough approximations only. A further limitation is imposed by the lack of suitable allowances for changes in quality. As tentative estimates, however, the divergent move-

Postwar Department Store Sales Second Federal Reserve District

(Percentage change between seasonally adjusted data for selected months)

Period	Dollar sales	Prices#	Apparent physical volume
January 1919 to May 1920	+58	+39	+14
September 1945 to June 1948	+54	+33	+16
May 1920 to September 1921	−19	−30	+17
June 1948 to November 1949*	−16	− 5	−11
January 1919 to September 1921	+28	− 4	+33
September 1945 to November 1949*	+30	+26	+ 3

* November 1949 preliminary estimate.

\# See footnote to chart for source and method of estimating.

ments in prices and physical volumes, as well as the general levels of the magnitudes involved, fit the testimony from business reports of the times.

Other similarities, perhaps only accidental, and other differences, no doubt incidental to the altered nature of the economy, appear from an examination of the two postwar periods, although activity in the second was, of course, on a much higher level. The expansions in dollar terms prior to the readjustments were not very different (although the second was spread over about twice as long a period)—58 per cent between January 1919[1] and May 1920, compared with 54 per cent from September 1945 to June 1948. Much smaller but closely comparable growths occurred in physical volume, as the accompanying table indicates. But whereas the decline in physical volume after the World War I boom coincided closely in timing with the first months of the lag in dollar sales, and was apparently of very brief duration, after World War II a peak in physical volume occurred long before the expansion in dollar sales had run its course. Inadequacies of the price data and the lack of adjustment for improvements in quality may very well mask the exact timing of the turning point and the magnitude of the subsequent decline, but that some definite decline occurred before 1948 seems a warranted conclusion.[2] Thus, the estimated 16 per cent increase in physical volume between September 1945 and June 1948 represents the *net* increase across that interval, not the maximum postwar rise.

At the end of the full period of rise and fall of dollar sales after World War I and after World War II to date, there remained almost equal net gains (28 and 30 per cent) in the dollar sales indexes. Prices, however, showed dissimilar courses. They were most likely somewhat lower in September 1921 than in January 1919 but were, according to indexes of retail prices, about 25 per cent higher in November 1949 than in September 1945. Hence the record indicates a net gain of one third in physical volume for the period after World War I but only a negligible one for the period just past. The difference may be explained at least in part by the shift in consumer expenditures to a greater extent during the past year or two than after World War I from department store type merchandise to automobiles, appliances, and new homes and—perhaps more important—the sustained high cost of food in the recent period compared to the drop of at least one third in 1920-21.

[1] Earlier sales data not available.
[2] The likelihood that unit sales in 1947 were already below those of the year before was discussed in this bank's *Review* of January 1948, p. 11.

Indexes of Department Store Sales and Stocks Second Federal Reserve District
(1935-39 average=100 per cent)

Item	1948	1949		
	Oct.	Aug.	Sept.	Oct.
Sales (average daily), unadjusted	281r	171	243	243
Sales (average daily), seasonally adjusted	253r	234	241	219
Stocks, unadjusted	268r	204	225	244
Stocks, seasonally adjusted	237r	204	213	216

r Revised.

Department and Apparel Store Sales and Stocks, Second Federal Reserve District, Percentage Change from the Preceding Year

Locality	Net sales		Stocks on hand Oct. 31, 1949
	Oct. 1949	Jan. through Oct. 1949	
Department stores, Second District	−13	− 8	− 9
New York City	−14	− 9	−10
Northern New Jersey	− 9	− 7	− 4
Newark	−10	− 8	− 3
Westchester County	−11	+ 3	+ 7
Fairfield County	−16	−10	−13
Bridgeport	−16	−11	−14
Lower Hudson River Valley	−12	− 6	− 8
Poughkeepsie	−14	− 5	−11
Upper Hudson River Valley	−18	− 6	−12
Albany	−19	− 8	−18
Schenectady	−22	− 4	− 3
Central New York State	−11	− 7	−11
Mohawk River Valley	−16	−11	−16
Utica	−14	− 9	−19
Syracuse	− 8	− 6	− 8
Northern New York State	−13	− 7	−17
Southern New York State	−16	−10	−11
Binghamton	−17	−10	−11
Elmira	− 8	− 9	−14
Western New York State	−14	− 5	− 7
Buffalo	−13	− 3	− 7
Niagara Falls	−12r	− 7r	− 8
Rochester	−16	− 9	− 8
Apparel stores (chiefly New York City)	−23	−11	−11

r Revised.

Indexes of Business

Index	1948	1949		
	October	August	Sept.	October
Industrial production*, 1935-39 = 100 (*Board of Governors, Federal Reserve System*)	195	170	174	166p
Electric power output*, 1935-39 = 100 (*Federal Reserve Bank of New York*)	257	258	255	256p
Ton-miles of railway freight*, 1935-39 = 100 (*Federal Reserve Bank of New York*)	208	154	154p	
Sales of all retail stores*†, 1935-39 = 100 (*Department of Commerce*)	338	330	336	331p
Factory employment				
United States#, 1939 = 100 (*Bureau of Labor Statistics*)	158	141	144	140p
New York State, 1935-39 = 100 (*NYS Div. of Placement and Unemp. Ins.*)	127	113p	118p	117p
Factory payrolls				
United States#, 1939 = 100 (*Bureau of Labor Statistics*)	367	323	335p	
New York State, 1935-39 = 100 (*NYS Div. of Placement and Unemp. Ins.*)	294	264p	283p	278p
Personal income*, 1935-39 = 100 (*Department of Commerce*)	315r	308	307p	
Composite index of wages and salaries*‡, 1939 = 100 (*Federal Reserve Bank of New York*)	194	199	199p	
Consumers' prices, 1935-39 = 100 (*Bureau of Labor Statistics*)	174	169	170	169
Velocity of demand deposits*, 1935-39 = 100 (*Federal Reserve Bank of New York*)				
New York City	108r	110	106	106
Outside New York City	93	89	89	89

* Adjusted for seasonal variation. p Preliminary. r Revised.
† Revised beginning January 1943. # Revised beginning January 1941.
‡ A monthly release showing the 15 component indexes of hourly and weekly earnings in nonagricultural industries computed by this bank will be sent upon request. Tabulations of the monthly indexes, 1938 to date, may also be procured from the Research Department, Domestic Research Division.

NATIONAL SUMMARY OF BUSINESS CONDITIONS

(Summarized by the Board of Governors of the Federal Reserve System, November 28, 1949)

OUTPUT and employment at factories and mines decreased in October but increased in the latter part of November. New construction activity was maintained at a high rate in October and the first half of November. Department store sales showed a less than seasonal increase. Commodity price changes continued to be relatively small. Prices of common stocks and bonds generally advanced.

Industrial Production

The Board's seasonally adjusted index of industrial production was 166 per cent of the 1935-39 average in October as compared with 174 in September and 170 in August. Following settlement of the steel labor dispute and resumption of operations at bituminous coal mines, total industrial production has increased in November.

Activity in durable goods industries declined about 12 per cent in October. The decrease reflected mainly sharp curtailment in output at blast furnaces, steel works, and rolling mills. Steel ingot production was reduced from a rate of 84 per cent of capacity in September to 11 per cent in October. Since early November, however, ingot production has increased again, and during the fourth week was scheduled at 78 per cent of capacity. Activity in iron and steel fabricating industries declined only slightly in October, but in early November apparently was reduced considerably mainly as a result of temporary steel shortages. Owing in part to model changeovers the number of passenger cars and trucks assembled was reduced from the record September rate by about one tenth in October and by one fifth in the first three weeks of November. Deliveries of copper to fabricators increased sharply in October, and output of furniture, electrical appliances, and most building materials continued to advance.

Output of nondurable goods showed a further rise in October as a result mainly of substantial increases in the textile, paper, and printing industries. Activity in these lines in October was generally at about the high levels prevailing last autumn. Output of petroleum products also increased in October but in early November was curtailed because of large stocks. Activity in most other nondurable goods industries in October showed little change.

As a result of work stoppages at bituminous coal and iron mines, minerals output declined considerably further in October. Anthracite production, however, increased substantially and crude petroleum output continued to expand. In November, bituminous coal production has advanced sharply.

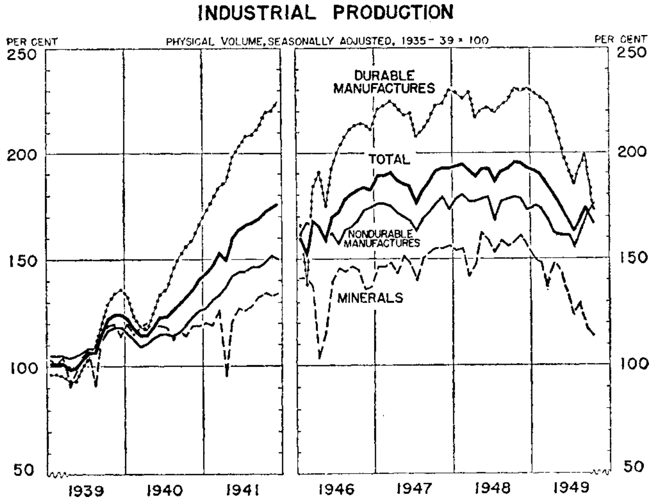
Construction

Value of construction contracts awarded in October, according to the F. W. Dodge Corporation, was maintained at the exceptionally high September level. Increases in public awards, following declines in August and September, offset small declines in awards for most types of private construction. The number of residential units started in October, as estimated by the Bureau of Labor Statistics, was 100,000, the same number as in September and 27,000 more units than in October 1948.

Employment

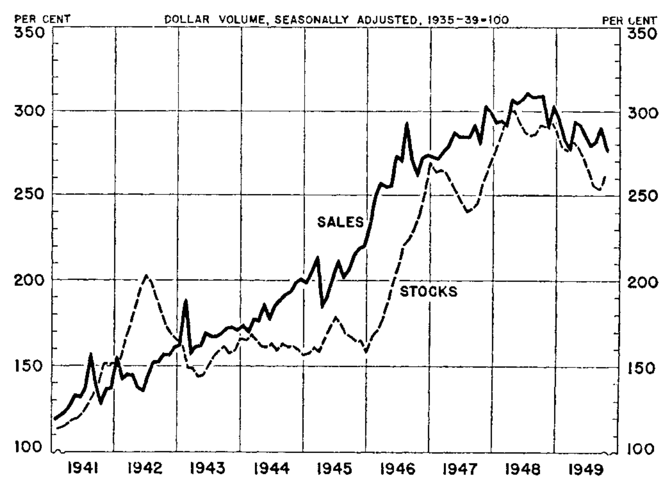
Employment in nonagricultural establishments declined 2 per cent in October owing mainly to reductions in durable goods manufacturing, mining, and transportation industries as a result of the steel and coal labor disputes. Unemployment rose one-quarter million in early October.

INDUSTRIAL PRODUCTION



Federal Reserve indexes. Monthly figures; latest shown are for October.

DEPARTMENT STORE SALES AND STOCKS



Federal Reserve indexes. Monthly figures; latest figure for sales is October; latest for stocks is September.

Distribution

Department store sales were 275 per cent of the 1935-39 average in October, according to the Board's seasonally adjusted index, as compared with 289 in September, and an average of 286 for the first nine months. In the first three weeks of November sales were 6 per cent below year-ago levels when the sales index for the month was 290.

Shipments of railroad revenue freight declined considerably in October reflecting chiefly sharply curtailed shipments of coal, iron ore, and steel products. Loadings increased in the middle of November, reflecting mainly sharp gains in coal shipments; loadings of miscellaneous freight showed a moderate expansion.

Commodity Prices

The average level of wholesale commodity prices declined somewhat further from mid-October to the third week of November, reflecting chiefly seasonal decreases in prices of livestock and meats. Spot prices of apparel wool, lead, and tin also declined owing in part to earlier reductions in foreign markets, while coffee prices showed a sharp increase. Steel scrap prices rose above prestrike levels and prices of some additional domestic industrial products were advanced in November.

Bank Credit

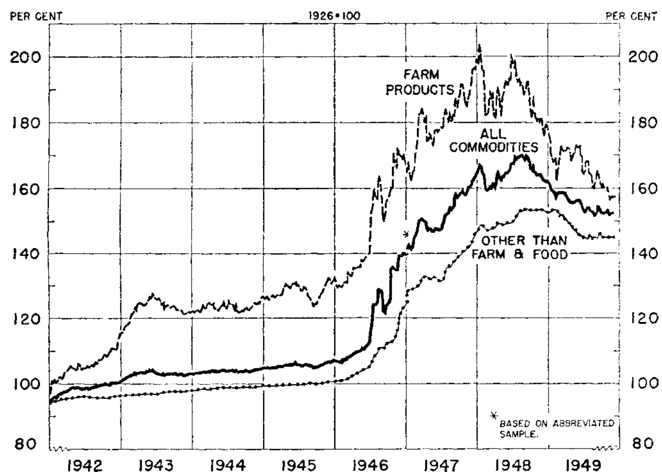
Business loans at banks in leading cities continued to expand seasonally during October and the first half of November. Loans on real estate and loans to consumers also increased. Holdings of U. S. Government securities rose during October but subsequently declined early in November.

A small reduction in gold stock and a seasonal outflow of currency into circulation tended to reduce member bank reserves in the first three weeks of November. Federal Reserve Bank credit expanded, however, reflecting primarily purchases of Government securities by the System.

Security Markets

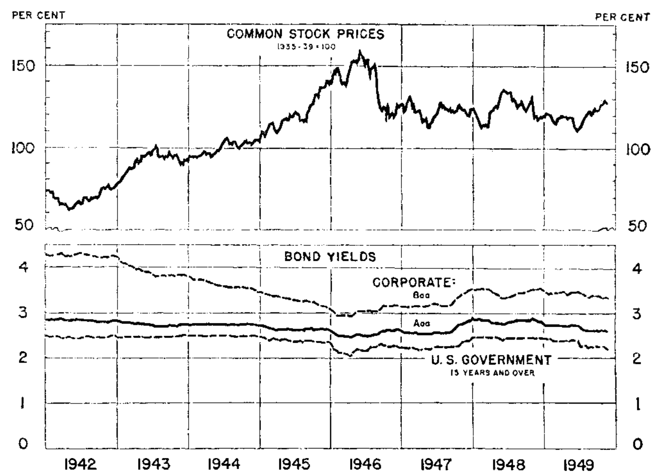
A steady rise in prices of most long-term Government bonds during the first three weeks of November has been accompanied by a moderate increase in prices of high-grade corporate bonds. Common stock prices have fluctuated around the new high level for the year reached in early November. New corporate security issues have continued in small volume.

WHOLESALE COMMODITY PRICES



Bureau of Labor Statistics' indexes. Weekly figures; latest shown are for week ended November 22.

SECURITY MARKETS



Common stock prices, Standard & Poor's Corporation; corporate bond yields, Moody's Investors Service; U. S. Government bond yields, U. S. Treasury Department. Weekly figures; latest shown are for week ended November 19.

MONTHLY REVIEW

SUPPLEMENT

FEDERAL RESERVE BANK OF NEW YORK

Vol. 31 DECEMBER 1949 No. 12

Gold, Monetary Management and the Banking System

Remarks of Allan Sproul,
President, Federal Reserve Bank of New York
at the
Seventy-Fifth Annual Convention of the
American Bankers Association
San Francisco, California
November 2, 1949

Remarks of ALLAN SPROUL,

President, Federal Reserve Bank of New York

at the

SEVENTY-FIFTH ANNUAL CONVENTION OF THE

AMERICAN BANKERS ASSOCIATION

San Francisco, California

November 2, 1949

AS A NATIVE CALIFORNIAN—and a native San Franciscan—I have tried to think of something I might discuss which would be of special interest to our generous hosts at this convention. The fact that this is 1949, and that the whole State of California has been engaged in a two-year round of celebrations of the 100th anniversary of the discovery of gold in California, and of its immediate consequences, gave me an obvious lead. Gold is something in which we are all interested. Nor is this an untimely topic on other grounds. The recent wave of currency devaluations which swept around the world, following upon the devaluation of the British pound sterling six weeks ago, has fanned into modest flame the always smouldering fires of the gold controversy. In addition, I was eager to review the gold question because it is a good starting point for an understanding of the place of the Federal Reserve System in the monetary and economic life of the country. When I finish with gold, I shall want to say something more specific about the System, and about your relations with it.

As central bankers, of course, charged with responsibility for our monetary and credit policies, we have the question of gold under more or less constant surveillance. Most of the time, in recent years, we have been under attack from two sides because of our attitude toward gold. Those interested primarily or initially in the price of gold, and in what they call a free gold market, have fired from one side. Those interested primarily and eternally in gold coin convertibility—in a full and automatic gold standard domestically and internationally—have fired from the other. More recently, we have had a brief respite from attack while these two groups fired at each other, each group arrogating to itself responsibility for the only true gospel according to St. Midas. What I have to say will probably bring that brief respite to an end. The fire will again be concentrated on the monetary authorities, for whom I cannot presume to speak except as one individual engaged in the practice of central banking, but who will, no doubt, be blamed for my views.

Let me take account of each of these two groups separately; those who concentrate, at least initially, on a free gold market, and those who will have none of this heresy, but who want a fixed and immutable gold price and convertibility of currency —and therefore of bank deposits—into gold coin.

The first group, which includes the gold miners, makes its argument on several grounds, trying to combine economics and psychology with self-interest. Let me paraphrase their principal arguments as presented at hearings on bills to permit free trading in gold in the United States and its territories. In this way I may avoid the fact as well as the appearance of building straw opponents. The arguments most frequently presented in favor of these bills were:

1. In the face of rising production costs and fixed selling prices, the gold mining industry has been forced to curtail its operations, and to the extent that it has operated, its profits have been reduced. The higher gold prices which would presumably prevail in a free market would correct this situation. This is the "do something for the gold miners" argument at its baldest.

When this argument is embroidered a little, it is claimed that since the prices of all goods and services have increased so substantially during the past ten or fifteen years, it is necessary to open the way for an increase in the price of gold so as to be sure there will be enough gold to carry on the country's business; to bring the price of gold into adjustment with the prices of everything else.

2. A second group of arguments expresses concern over the unsettling effects of the "premium" prices which are paid for gold abroad, and claims that a free gold market in the United States, with no gold export restrictions, would cause these premium markets abroad to disappear, with beneficial effects upon world trade and international relations.

3. Third, there is an argument in equity—that gold miners should be allowed to sell their product at the best price they can obtain, as do producers of other products; and that American citizens, like the citizens of most other countries, should be free to hold or to buy and sell gold.

4. Finally, there were those who viewed and favored a free gold market as a first step in the direction of a full gold coin standard, and who held that even a free market would act as a "fever chart" of the economy and lead to reform of extravagant Government fiscal policies, remove inflationary tendencies fostered by a managed currency, and lead to sounder conditions, generally.

To take these arguments up in order, it should be pointed out right away that it is quite possible that a free market for gold in the United States would not result in a rise in the price of gold, if for no other reason than that the Secretary of the Treasury is required, by law, to maintain all forms of United States money at parity with the gold dollar which contains

1/35th of an ounce of fine gold. This means that the Treasury should maintain the price of gold at $35 a fine ounce in legal gold markets in the United States. To do this, if there were a legal free market for fine gold, the Treasury should sell gold to the extent necessary to maintain the market price at $35 a fine ounce. We might, therefore, get what would be in effect gold convertibility by way of a free market, but not a rise in the price of gold. Aside from this possible outcome of the establishment of a free market for gold, what is it we are being asked to do? In effect we are being asked to do something to benefit the gold mining industry, to encourage a shift of productive resources, in this and other countries, into gold production, in order to provide gold for hoarding. This, I submit, would be a witless proceeding, in terms of the welfare of the whole economy, matched only by our bonanza provisions for the special benefit of the miners of silver.

As for the economic embroidery of this request for aid to the gold mining industry, there is no lack of monetary means of carrying on the business of the country, nor is there likely to be. It is the economics of perpetual inflation to argue that a rise in the commodity price level should be followed by an arbitrary increase in the price of gold and hence in the reserve base, thus permitting and, perhaps, promoting additional deposit expansion and a further upward movement of prices. Even on the basis of statistics, which are not always reliable or comparable, it is interesting to note that the increase in the price of gold in the United States, in 1934, raised the price of gold by 69 per cent, whereas wholesale prices in the United States are now only 60 per cent above the 1927-29 level. We have been plagued, if anything, with an oversupply of money in recent years, and the United States gold stock, at the present price, is large enough to support whatever further growth in the money supply may be needed for years ahead.

The second group of arguments has to do with the desirability of knocking out of business the premium markets in gold which have existed and still exist in various foreign countries. I share the general dislike of these markets because they are parasites on the world's monetary system and help to siphon into gold hoards the resources of people who need food and clothing and equipment—and who wouldn't need so much help from us if they didn't use scarce foreign exchange to buy gold for private hoards. But I don't think the soundness nor the stability of the United States dollar is actually brought into question by these premium markets. At our official purchase price for gold—$35 a fine ounce—the United States has been offered and has acquired more gold than the total world production (excepting the U.S.S.R. for which reliable data on gold production, as on everything else, are not available), since 1934, the year of our devaluation. During those years—1934 to 1948 inclusive—estimated world gold production, valued at United States prices, was about $13.5 billion and United States gold stocks increased $16 billion. Most of the producers and holders of gold have been quite willing to sell us gold for $35 a fine ounce despite the quotations of $45 and $55 and so on up in the premium markets. The fact is that these premium markets represent insignificant speculative adventures around the fringe of the world supply and demand for gold. They reflect mainly the urgent and often illegal demands of a small group of hoarders, together with some private demand for gold to be used in relatively backward areas, or areas where the forms of civilized government have broken down, and where the metal serves the needs of exchange—or hoarding—better than a paper note. I do not think there would be any appreciable stimulus to United States gold production, if we opened the doors of this largely clandestine trade to our domestic gold miners. But, by legalizing it, we might well create what we are trying to destroy—uncertainty about the stability of the dollar and our own intentions with respect to its gold content.

The third argument—that the miners of gold should be free to sell their product at the best price they can get—is probably the giveaway. It is the argument that gold should be treated as a commodity when you think you can get a higher price for it, and as a monetary metal and an international medium of exchange when you want a floor placed under its price. I would say that you can't have it both ways. If you want the protection of an assured market at a fixed price, because gold is the monetary metal of the country, you should not ask permission to endanger the stability of the monetary standard by selling gold at fluctuating prices (the gold producers hope higher prices) in a fringe free market. Under present conditions, the only real price for gold is the price the United States Treasury is prepared to pay for it. So long as that is the case, there is no sense in a "make believe" free gold market, in which possible temporary or short-run deviations from the fixed price of the Treasury might have disturbing consequences.

Nor is the argument that citizens of the United States should have the same privileges as the citizens of other countries, when it comes to holding or trading in gold, at all convincing to me. It is true that in a number of foreign countries the holding of gold by private citizens is legal, and in some foreign countries strictly internal free trading in gold is permitted. In many cases, however, this merely represents the shifting around of a certain amount of gold which is already being hoarded in the country, since in practically all of these countries the export and import of gold on private account is either prohibited or subject to license. And, in many countries where gold is produced, some percentage, if not all, of the newly mined gold must be sold to the monetary authorities, a requirement which further limits the amounts available for trading and hoarding. These restricted and circumscribed privileges in other countries are no reflection of a loss of inalienable rights by our people. They are attempts by these foreign countries to adjust their rules with respect to gold to their own self-interest and, so far as possible, to the habits of their people, all under the sheltering umbrella of a world gold market and a world gold price maintained by the Treasury of the United States. We have deemed it wise to maintain such a fixed point of reference, in a disordered world. We have decided by democratic processes and by Congressional action, that this policy requires, among other things, that gold should not be available for private use in this country, other than for legitimate industrial, professional, or artistic purposes. We have decided that the place for gold is in the monetary reserves of the country, as a backing for our money supply (currency and demand deposits of banks), and as a means of adjusting international balances, not in the pockets or the hoards of the people. If we want to reverse that decision, the means of reversal are at hand, but it should be a clear cut and a clean cut reversal, restoring convertibility. Providing a dependent free gold market, in which gold miners and a little gold group of speculative traders or frightened gold hoarders (such as those who now take advantage of a provision in the regulations to buy and sell "gold in the natural state") could carry on their business is not the way to meet the problem.

I do not propose to get in the cross fire of those who claim that a free gold market would be a step toward convertibility, and those who claim that a free gold market, without free coinage at a fixed price, would cause us to lose whatever modicum of a gold standard we now have and lead to monetary chaos. That is one of those doctrinal arguments in which the subject abounds. I will merely say here that I think authorization of a free gold market in this country, with no change in the present responsibility of the Secretary of the Treasury to maintain all forms of money coined or issued by the United States at parity with the "gold dollar", would probably lead indirectly to convertibility. The desirability of doing this is another matter, which I shall now try to discuss briefly and dispassionately. This is a hazardous attempt because there is no subject in the field of money and banking which so arouses the passions, and which so readily defies brief analysis.

Two groups of arguments for the reestablishment of a gold coin standard may, perhaps, be distinguished in the writings and speeches of those who propose it, one group relating primarily to the domestic economy and one to the probable effects on international trade and finance. In the first group the arguments run about as follows:

1. Replacement of our "dishonest", inconvertible currency with an "honest" money having intrinsic value would promote confidence in the currency, and encourage savings, investment, long-time commitments, and production.

2. Irredeemable paper money leads to inflation, whereas the upper limits imposed upon currency and credit expansion by a thoroughgoing gold standard serve as a restraining influence on irresponsible politicians and over-optimistic businessmen.

3. Present Governmental taxing and spending policies are wrong, and dangerous. The gold standard would put a brake on public spending.

4. As a corollary of the preceding argument, since the gold standard would hinder further extension of Government control and planning, it is a necessary implement of human liberty.

The second group of arguments, relating to the international advantages of a gold coin standard, generally make no distinction between the effects of a unilateral adoption of such a standard by the United States, and the multilateral establishment of an unrestricted gold standard by many countries, and of exchange rates fixed by such a standard. The arguments run somewhat as follows:

1. The existence of premium markets in gold abroad and the lack of gold convertibility at home creates—and is representative of—lack of confidence in the gold value of the dollar. In the absence of a thoroughgoing gold coin standard we cannot convince anyone that we may not devalue the dollar.

2. Restoration of "normal" patterns of international trade is being retarded by the inconvertibility of currencies in terms of gold and, therefore, one with another. This inconvertibility has led to tariffs, quotas, exchange controls, and to general bilateralism.

3. Under a managed paper currency system there is always the temptation to solve national problems by devices which lead to international disequilibrium. This, in turn, has led to domestic devices restrictive of foreign trade. The international gold standard, by eliminating the need for restrictive commercial policy, would increase the physical volume of international trade, resulting in an improved division of labor and higher standards of living for everyone.

First, let me say that I perceive no moral problem involved in this question of gold convertibility. Money is a convenience devised by man to facilitate his economic life. It is a standard of value and a medium of exchange. Almost anything will serve as money so long as it is generally acceptable. Many things have served as money over the centuries, gold perhaps longest of all because of its relative scarcity and its intrinsic beauty. In this country we still retain some attachment to gold domestically, and more internationally, but to carry on our internal business we use a paper money (and bank deposit accounts) which has the supreme attribute of general acceptability. There is no widespread fear of the soundness of the dollar in this country, no widespread flight from money into things. The constant cry of wolf by a few has aroused no great public response. Savings, investment, long-term commitments, and the production and exchange of goods have gone forward at record levels.

Much of the nostalgia for gold convertibility is based, I believe, on fragrant memories of a state of affairs which was a special historical case; a state of affairs which no longer exists. The great period of gold convertibility in the world was from 1819 to 1914. It drew its support from the position which Great Britain occupied, during most of the 19th century and the early part of the 20th century, in the field of international production, trade, and finance. The gold coin standard flourished because the organization of world trade under British leadership provided the conditions in which it could, with a few notable aberrations, work reasonably well.

The ability of the British to sustain, to provide a focal point for this system has been declining for many years, however, and the decline was hastened by two world wars which sapped the resources of the British people. The heir apparent of Great Britain, of course, was the United States, but up to now we have not been able to assume the throne and play the role. And until some way has been found to eliminate the lack of balance between our economy and that of the rest of the world, other than by gifts and grants in aid, we won't be able to do so. This is a problem of unravelling and correcting the influences, in international trade and finance, which have compelled world-wide suspension of gold convertibility, not vice versa. The job before us now is to attack the problems of trade and finance directly. We should not deceive ourselves by thinking that gold convertibility, in some indefinable but inexorable way, could solve these underlying problems for us.

Nor is it true, of course, that gold convertibility prevented wide swings in the purchasing power of the dollar, even when we had convertibility. Within my own experience and yours, while we still had a gold coin standard, we had tremendous movements in commodity prices, up and down, which were the other side of changes in the purchasing power of the dollar. What happened to us in 1920-21 and 1931-33 under a gold coin standard should prevent a too easy acceptance of that standard as the answer to the problem of a money with stable purchasing power.

When you boil it all down, however, and try to eliminate mythology from the discussion, the principal argument for restoring the circulation of gold coin in this country seems to be distrust of the money managers and of the fiscal policies of Government. The impelling desire is for something automatic and impersonal which will curb Government spending and throw the money managers out of the temple, as were the money changers before them. To overcome the inherent weakness of human beings confronted with the necessity of making hard decisions, the gold coin standard is offered as an impersonal and automatic solution. Through this mechanism the public is to regain control over Government spending and bank credit expansion. It is claimed that whenever the public sensed dangerous developments, the reaction of many individuals would be to demand gold in exchange for their currency or their bank deposits. With the monetary reserve being depleted in this way, the Government would be restrained from deficit financing through drawing upon new bank credit; banks would become reluctant to expand credit to their customers because of the drain on their reserves; and the Federal Reserve System would be given a signal to exert a restraining influence upon the money supply. In this way, Congress, the Treasury, and the Federal Reserve System would be forced by indirection to accept policies which they would not otherwise adopt.

In effect, under a gold coin standard, therefore, the initiative for over-all monetary control would, through the device of free public withdrawal of gold from the monetary reserve, be lodged in the instinctive or speculative reactions of the people. No doubt some people would take advantage of their ability to get gold. There would be many reasons for their doing so. Conscientious resistance to large Government spending, or fear of inflation, might well be among these reasons. But speculative motives, a desire for hoards (however motivated), and such panic reactions as are generated by unsettled international conditions or temporary fright concerning the business outlook or one's individual security—all of these, and more—would be among the reasons for gold withdrawals. The gold coin mechanism does not distinguish among motives. Whenever, for any reason, there was a demand for gold, the reserve base of the monetary system would be reduced. Moreover, if only the United States dollar were convertible into gold while practically all other currencies were not, hoarding demands from all over the world would tend to converge upon this country's monetary reserves. Circumvention of the exchange controls of other countries would be stimulated, and dollar supplies which those countries badly need for essential supplies or for development purposes would be diverted to the selfish interests of hoarders.

Even if a particular reduction in the reserve base did occur for useful "disciplinary" reasons, the impact of such gold withdrawals upon the credit mechanism is likely to be crude and harsh. Since the present ratio between gold reserves and the money supply is about one-to-five, and since some such ratio will be in effect so long as this country retains a fractional reserve banking system, a withdrawal of gold coins (once any free gold is exhausted) will tend to be multiplied many times in its contractive effect on bank credit and the money supply. In a business recession, the Reserve System might undertake to offset this effect as it does now in the case of gold exports but, if the gold withdrawals attained sufficient volume, the shrinking reserve position of the Federal Reserve Banks would eventually prevent them from coming to the rescue.

It was, in part, to offset such arbitrary and extreme influences upon the volume of credit, and to make up for the inflexibility of a money supply based on gold coins (in responding to the fluctuating seasonal, regional, and growth requirements of the economy), that the Federal Reserve System was initially established. During the first two decades of its existence, the System devoted much of its attention to offsetting the capricious or exaggerated effects of the gold movements associated with continuance of a gold coin standard. We had an embarrassing practical experience with gold coin convertibility as recently as 1933, when lines of people finally stormed the Federal Reserve Banks seeking gold, and our whole banking mechanism came to a dead stop. The gold coin standard was abandoned, an international gold bullion standard adopted, because repeated experience has shown that internal convertibility of the currency, at best, was no longer exerting a stabilizing influence on the economy and, at worst, was perverse in its effects. Discipline is necessary in these matters but it should be the discipline of competent and responsible men; not the automatic discipline of a harsh and perverse mechanism.

If you are not willing to trust men with the management of money, history has proved that you will not get protection from a mechanical control. Ignorant, weak, or irresponsible men will pervert that which is already perverse.

Here, I would emphasize my view that the integrity of our money does not depend on domestic gold convertibility. It depends upon the great productive power of the American economy and the competence with which we manage our fiscal and monetary affairs. I suggest that anyone who is worried about the dollar concentrate on the correction of those tendencies in our economic and political life which have brought us a deficit of several billion dollars in our Federal budget, at a time when taxes are high and production, employment, and income are near record levels. I suggest that, going beyond the immediate situation, they address themselves to the difficult problem of the size of the budget, whether in deficit or surplus or balance. At some point the mere size of the budget, in relation to national product, can destroy incentives throughout the whole community, a dilemma which is even now forcing curtailment of Government expenditures by the Labor government in Great Britain. These are problems gold coin convertibility cannot solve under present economic and social conditions. Gold has a useful purpose to serve, chiefly as a medium for balancing international accounts among nations and as a guide to necessary disciplines in international trade and finance. It has no useful purpose to serve in the pockets or hoards of the people. To expose our gold reserves to the drains of speculative and hoarding demands at home and abroad strikes me as both unwise and improvident.

Perhaps before I let go of this subject, which has held me and you overlong, I should say a word about merely raising the price of gold, without doing anything about a free gold market or gold coin convertibility of the currency. This is something which has intrigued Europeans and others who are "short of dollars", has interested some of our own people, and has become a South African war cry. An increase in the price the United States pays for gold would have two major results. It would provide the gold producing countries (and domestic producers), and the countries which have sizable gold reserves or private hoards, with additional windfall dollars with which to purchase American goods. And it would provide the basis for a manifold expansion of credit in this country which might be highly inflationary.

We have been engaged in an unprecedented program of foreign aid for the past four years. The Congress has authorized this aid at such times and in such amounts as were deemed to be in the interest of the United States. This is much to be preferred, I suggest, to the haphazard aid which would be granted by an increase in the price of gold, which must be on the basis of a more or less accidental distribution of existing gold stocks and gold producing capacity. If we raised the price of gold, every country which holds gold would automatically receive an increase in the number of dollars available to it. The largest increases would go to the largest holders which are the Soviet Union, Switzerland, and the United Kingdom. Every country which produces gold would automatically receive an annual increase in its dollar supply, and its gold mining industry would be stimulated to greater productive effort. The largest increases would go to the largest producers which are South Africa, Canada, and probably the Soviet Union. That would be an indiscriminate way to extend our aid to foreign countries, both as to direction and as to timing.

The domestic results of an increase in the price of gold would be no less haphazard. This country, as I have said, is not now suffering from a shortage of money and it has large gold reserves, which could form the basis of an additional money supply if we needed it. An increase in the dollar price of gold would increase the dollar value of our existing gold reserves in direct proportion to the change in price. There would be an immediate "profit" to the Treasury. The "profit" could be spent by Congressional direction or Treasury discretion. This would provide the basis for a multiple expansion of bank credit which, unless offset by appropriate Federal Reserve action, would expose our economy to the threat of an excessive expansion of the domestic money supply. The arbitrary creation of more dollars in this way would certainly be inappropriate under inflationary conditions, and would be an ineffective method of combating a deflationary situation.

At the moment, also, we should have in mind that there has just been an almost worldwide devaluation of currencies. Using the fixed dollar as a fulcrum, individual foreign countries have taken action designed to improve their competitive position vis-a-vis the United States, and to maintain their competitive position vis-a-vis one another. An increase in the dollar price of gold, which is devaluation of the dollar by another name, would undo the possible benefits of a venture in improved currency relationships which already has its doubtful aspects.

For all of these reasons it is encouraging to know that the Secretary of the Treasury has recently reiterated that the gold policy of the United States is directed primarily toward maintaining a stable relationship between gold and the dollar, and that for all practical purposes only the Congress can change that relationship. We have maintained an international gold bullion standard by buying and selling gold freely at a fixed price of $35 a fine ounce in transactions with foreign governments and central banks for all legitimate monetary purposes. This has been one fixed point in a world of shifting gold and currency relationships. We should keep it that way as another contribution to international recovery and domestic stability.

This whole discussion of gold has been a long wind-up for what may now seem to you like a small pitch. I want to end my remarks with a few words about the Federal Reserve System and the relations of your organization and you, as bankers and citizens, with that System.

In my gold discussion I tried to emphasize what seems to me to be a fundamental proposition in the case of a country with the domestic and international strength of the United States. We can't have, or we don't want, both an automatic gold coin standard and discretionary control of the reserve base by a monetary authority. The existence of two independent and frequently incompatible types of control over the reserves of our banking system is undesirable. In the light of that finding we abandoned the gold coin standard as a control over the domestic money supply, and placed our reliance in monetary management by the Federal Reserve System. I think it has become established American policy that a principal means of Government intervention in the economic processes of the country is the administration of broad credit powers by the System. In this way a pervasive influence may be brought to bear on our economy, without intrusion upon specific transactions between individuals, which is likely to be the consequence of more detailed physical controls, and which would spell the end of democratic capitalism as we have known it.

I have thought it reasonable to assume that the public in general, and bankers in particular, clearly recognized the special place of the System in our economy. The fact that the development of a national monetary and credit policy is the responsibility of the Federal Reserve System should fix its place beyond question. This is not a function which can be split up and passed around. Many of the activities of other Government agencies engaged in making or guaranteeing loans, or conducting bank examinations, or insuring bank deposits, have a bearing on the way monetary policy works, but monetary policy, as such, is one and indivisible. It is only the supervisory and service functions performed by the Federal Reserve System which are comparable to the operations of these other Government agencies. The distribution of these incidental duties among such agencies can be largely determined by administrative convenience, historical precedent, and economy of operation, so long as there are arrangements for consultation to avoid unnecessary differences in policy and practice. But overall responsibility for holding the reserves of the banking system, and influencing the creation of credit by varying the cost and availability of those reserves, can only reside in the one agency designated by Congress as the national monetary authority. The Federal Reserve System is not just one of a number of Federal agencies having to do with banking. Its duties and responsibilities are unique; they range over the whole of our economy and touch the lives of all our people.

I was somewhat dismayed, therefore, by recent reports that the American Bankers Association seemed to hold a different or opposite view. It is reported to have recommended to the Congress the maintenance of parity of compensation of the three Federal bank supervisory agencies (Board of Governors of the Federal Reserve System, Board of Directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency), on the theory of equal pay for equal work; equal pay for sharing equally heavy responsibilities. I mean no disrespect of the Office of the Comptroller of the Currency, nor of the Federal Deposit Insurance Corporation, when I say there is and can be no such equality of responsibility. The bank supervisory duties of the Federal Reserve System are a distinctly minor part of its work. There is no desire to increase or add to those duties against the wishes of the banks or the best interests of the public. To represent the Federal Reserve System as just another bank supervisory agency, in the name of maintaining proper checks and balances in Federal bank supervision, seems to me to miss, and to misrepresent, the main reason for our being.

I mention this small but significant item first, because it cuts across the whole concept of the Federal Reserve System and, therefore, cuts across the whole range of our relationships with you. There are other points of apparent difference where we seem to be at odds, or not pulling together effectively, because of mistrust, or lack of proper consultation, or inadequate study of the broad aspects of the questions with which we are mutually concerned. I shall touch on a few of them.

Concentration of Power—The picture of a Federal Reserve System trying to arrogate power to itself, which at times you have painted, obscures the real picture. The real picture would show a Federal Reserve System trying hard to keep its powers in working order so that it can discharge its responsibilities as a monetary authority, with a measure of independence from the pressures of partisan political aims and the exigencies of managing a Federal debt which totals about 255 billion dollars and, unfortunately, is growing. To lump the Federal Reserve System with the other bank supervisory agencies at Washington, and to play one against the other, is not an attack on the real concentration of power; it is giving aid and comfort to those who would seize upon the failure of monetary and credit controls as a pretext for fastening more direct controls upon our economy.

Organization of the Federal Reserve System—I have been at one with many of you in my opposition to undue centralization of control of the Federal Reserve System by the Board of Governors at Washington. In testimony before Congressional committees and in public statements, I have affirmed my belief that we can have in the Federal Reserve System a wise blend of national authority and regional responsibility, of Government control and private participation. I think we shall do well to retain and to improve the regional characteristics of the System, both in matters of decentralized operation and, more important, in matters of national credit policy. I should like to see the bankers of the country, and this organization of bankers, give some more thought to this problem, and I should like them to offer some constructive suggestions concerning it. The climate may be right for its calm consideration.

Reserve Requirements—The Federal Reserve System is charged with the responsibility of formulating and administering national credit policy. It does this chiefly through its influence upon the cost and availability of bank reserves. This is a proper exercise of Federal power, and its point of incidence is upon the commercial banks of the country because only they, among all of our financial institutions, have the ability to add to or subtract from the money supply of the nation. I question whether there is good and sufficient reason for exempting any commercial banks from a minimum participation in this national undertaking. It only requires a moderately sharp pencil and a grammar school knowledge of arithmetic to figure out how you can save money by not being a member of the Federal Reserve System, as things now stand. But I don't think this country really likes "free riders", and nonmember banks, in that sense, are "free riders". I know the objections to compulsory membership in the Federal Reserve System, I recognize some of its dangers, and I think it is probably politically impossible. But it should not be beyond our ingenuity to devise appropriate powers of fixing reserve requirements, to be exercised within statutory limits by an appropriate body within the Federal Reserve System; reserve requirements which would be adequate for our national purpose, and which would apply to member and nonmember banks alike.

Here is another instance, I believe, where your theory of checks and balances runs the danger of being all check and no balance. And let it be clear that this is no attack on the dual banking system. State member banks have lived within the Federal Reserve System for years, and submitted to its reserve requirements, without loss of identity. We welcome this continued relationship. Nor am I frightened by the existence of a fringe of nonmembers, and the ability of State banks to move from one group to the other. A mass exodus of State member banks from the Federal Reserve System seems to me to be so unlikely as to be outside the range of practical consideration. But I do think that all commercial banks have a common obligation and a common responsibility in this matter of reserve requirements, and that they should assume the obligation and share the responsibility.

Correspondent Bank Relationships—Somehow there has grown up a feeling in some places that we in the Federal Reserve System are out to undermine the network of correspondent bank relationships which you have built up over the years. Every time we suggest some change in the method of assessing reserve requirements, or make some minor improvement in our check collection system, or in our methods of providing coin and currency, or in some other detail of our operations, the question seems to be raised. I can assure you that these things are suggested or done in an effort to improve the efficiency and economy of our operations in terms of the whole banking system, the business community, and the general public. There is no hidden purpose. We recognize that there are some things which correspondent banks can do better than we can, and we are glad to have them perform these services. At the same time we would caution them against competition in providing services which really do not pay their way, and remind them that there are some things which, perhaps, the Federal Reserve System can do better than they. Surely here is an area, if our motives be reasonably pure on both sides, where there is no need for friction between us.

Selective Credit Controls—We have differed on the matter of selective credit controls or, more specifically, on the matter of control of consumer instalment credit. I have advocated the continuance of the control which the Federal Reserve System exercised, briefly, over consumer instalment credit. I would be concerned over the dangers of any further significant extension of selective controls, whether over the credit used in commodity markets, in real estate transactions, in inventory financing, or in other forms of business lending. Requests for further powers should meet two tests—is the power really needed and will its use still leave an effectively functioning private economy? I have argued and still believe that control of consumer instalment credit meets these tests. Your official position has been opposed to this view. I would ask you, however, whether you are happy about the way things are now going in this field of finance. I am not. I suggest that we might sit down together and reexamine the problem to our mutual advantage and to the advantage of the public which we both serve.

These are some of the matters which I think deserve your constructive attention. A negative approach has been and will continue to be effective in stopping the passage of individual pieces of legislation, which you happen to dislike, but it won't check the progress of the idea of Government controls and intervention, if you have little constructive to offer in the face of difficult economic problems. Over the years you will win a lot of battles but you will lose the war.

I recognize and share your dislike for Government controls and your distrust of too much centralized power. But I recognize, as I think you must, that a certain amount of Government intervention is necessary to the preservation of our political and economic system. The central problem in our country, and in all countries but Russia and its satellites, is how far such Government guidance and control can go without destroying the effective functioning of a private economy. In this country, with our traditions of individual enterprise, we have preferred to keep such guidance to a practical minimum, and to have it exercised largely through broad and impersonal controls—controls which affect the general environment. One cornerstone of such a philosophy is a competent and adequately powered monetary authority which can administer an effective monetary policy. In making monetary policy work to the limit of its capacity, we have one of the best defenses against control by Government intrusion in our personal and private affairs.

That is why I should like to see the American Bankers Association adopt an affirmative, constructive attitude toward the Federal Reserve System. If you don't like it, as it stands, put some real time and effort into the study of ways to improve it—its personnel, its powers, its organization, its functioning. In such an undertaking you will have the cooperation of all of us who are devoting our lives and our energies to what we believe to be a worthwhile public service. In the struggle of ideas and ideals which now divides the world this is a minor front. But it is a fighting front. It is no place for a neutral.