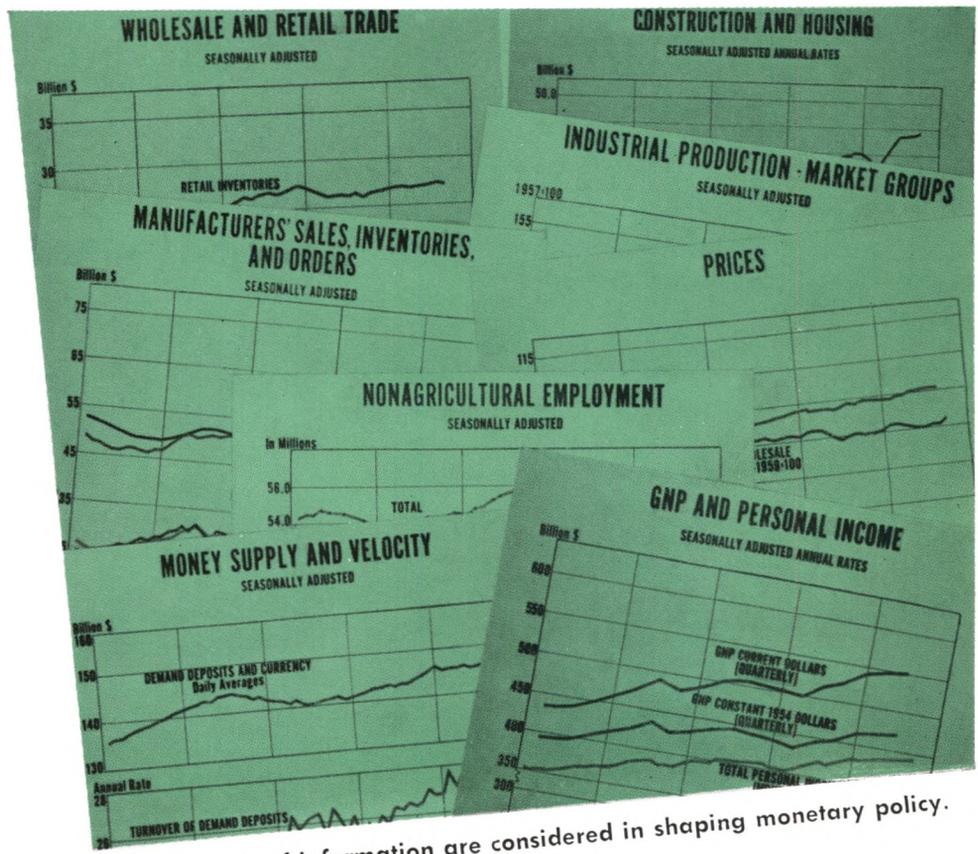


MONTHLY REVIEW



Many kinds of information are considered in shaping monetary policy.

CENTRAL BANKS

This is the fourth in a series of articles on central banks with special reference to the Federal Reserve System.

“Central banking is a subject that does not lend itself to precise definition and universal rules. Its essence is discretionary control of the banking system, but if we try to elaborate this we shall soon find ourselves at variance with what has been done or is being done by some central bank or other.” Thus Mr. R. S. Sayers, the eminent British economist, points out the central characteristics of central banks and notes their changing, evolving techniques.

Previous articles in this series have described the characteristics of central banks and discussed their major service functions. This paper discusses the most essential function of central banks—that of formulating and administering monetary policy.

THE MONETARY POLICY FUNCTION

In making and administering monetary policy, central banks aim at certain definite goals. Their methods and techniques vary because of institutional differences among countries, but all policy actions are aimed at the realization of one or more of those goals. A brief but broader look at the rationale or strategy of monetary policy will afford some perspective which will be helpful in the more detailed discussion which follows.

Goals Generally the goals of central banks are the same in all countries of the free world today. Briefly, they are to provide monetary and credit conditions favorable to the realization of: (1) a high level of employment; (2) relative stability in the general price level; (3) economic growth; and (4) stability of the country's monetary unit in international markets. A more complete explanation and discussion of these goals, and of the methods and techniques mentioned below, can be found in a number of publications such as *The Federal Reserve*

at Work published by this Bank and *The Federal Reserve System: Purposes and Functions* published by the Board of Governors.

Methods and Techniques To accomplish these broad goals central banks use various methods and techniques which have been developed over the past century, most of them during the last four decades. The more important ones are explained and discussed below, but perhaps it should be noted here that nearly all of them exert their effects through the reserves of commercial banks. In fact, a very large part of the work connected with monetary policy consists of creating, mobilizing, holding, and shifting reserves and setting reserve requirements. This is true because in modern banking systems the volume of bank credit and the size of the money supply are closely dependent on the amount of bank reserves and, to a lesser extent, on the distribution of reserves among banks which have different reserve requirements.

The manipulation of bank reserves and other monetary policy actions are, of course, not ends in themselves. Indeed, no monetary action is ever an end in itself, but rather the means to some more important economic purpose. What, then, is the relationship between the methods used to administer monetary policy and the goals of that policy? This question goes to the heart of monetary theory on which hundreds of volumes have been written. Here only a few sentences must suffice to summarize a very complex theory.

First, it is essential to note that money is not the driving force or the motive power which keeps the economy going. It is only the *medium* through which economic transactions are carried out. Or, to shift the analogy, it may be likened to the governor which regulates the speed of an engine by adjusting

Goals
High employment
Stability of prices
Economic growth
Stable exchange rate

Monetary Policy

Methods

Setting discount rate
Open market operations
Direct in
Other



the flow of fuel to the engine to meet varying loads. In the economy it is the demand for goods and services which provides the motive for economic activity—for production. But a shortage of money or very high interest rates may slow production by delaying the start of new projects, forcing the liquidation of inventories, and in other similar ways. Conversely, abnormally low interest rates and an overabundant money supply will cause inflation, encourage speculation, and stimulate a rate of economic activity which cannot be sustained. Central banks endeavor to provide an amount of bank reserves which will allow the banking system to maintain a money supply, and the market to set interest rates, which will strike a happy medium between the two situations described above. Of course there are many other factors which affect prices, production, and economic growth, and for that reason it is not possible to exercise any precise control over economic activity by monetary measures alone.

Certain conditions are essential if a central bank is to be effective in regulating money and credit. First, the central bank must have the necessary statutory powers and financial resources. Second, substantially all important commercial banks must be subject to the central bank's influence. Finally, willing and intelligent cooperation by the commercial banks will greatly facilitate the implementation of central bank policy. It follows that a central bank has a more difficult problem where there are many banks than where there are only a few. The problem is still further accentuated if any substantial number of the banks are not subject to the direct influence of the central bank or will not cooperate fully in its policies.

ADMINISTERING MONETARY POLICY

In the following sections various techniques of administering or applying monetary policy are discussed, roughly in the order in which they developed. Here attention is focused not on the detailed and precise way in which these techniques exert their effects but rather upon their broad and general characteristics and the ways in which they evolved. As noted above, most of these involve acting upon bank reserves. For that reason it may be well to look briefly at bank reserves before the advent of central banks.

Bank Reserves Before Central Banks In the absence of a central bank, private commercial banks must make their own arrangements for obtaining funds needed to meet cash demands of depositors. If a bank were completely independent and had no connection with other banks, it would have to hold in its own vaults enough legal tender to meet the largest probable cash withdrawals. If the demands should exceed that amount and if the bank were unable to obtain cash by selling assets, it would be seriously embarrassed if not forced to close. In the distant past, reserves equal to 30% to 40% of deposits were sometimes carried.

Banks can, however, substantially reduce the needed reserves by voluntary joint action. They can, through correspondent relations, carry accounts with each other, and agree to rediscount paper for, or make loans to, each other in time of need. On the logical assumption that they will not all experience their peak demands at the same time, they can by these means safely reduce the total reserves carried. The principle is much the same as the one whereby a group of householders can profit by joint action in fire protection. If each household must keep enough

water to provide adequate protection against fire, the total is very large. But if a hundred householders join together and build a water tank for the group, the total can be greatly reduced and still provide adequate protection. But in banking as in fire protection there is some risk of a general conflagration in which protection is needed everywhere at the same time. There is no complete protection against a monetary panic in which cash withdrawals would be excessive, but a strong central bank can provide much more protection than joint action by the banks themselves.

Central Bank Discounting As the early central banks developed it was natural for other banks to deposit a part of their reserves in such banks. In this way the central bank *mobilized* a large part of the bank reserves of the country at one point under one control. In the beginning the practice of placing reserves with the central bank was entirely voluntary, and it remains so in many countries today. The practice of *requiring* commercial banks to hold part or all of their reserves with the central bank was started with the establishment of the Federal Reserve System in 1913, but it has been adopted by many other countries since then.

One way in which central banks make available the mobilized reserves under their control is by discounting paper for, or making loans to, commercial banks. This may be ordinary or routine discounting to meet seasonal needs or special needs which develop with certain individual banks or in certain areas. Or it may be emergency discounting to meet a condition of great stringency or near panic, caused by a general lack of liquidity in the whole banking system. In the latter case the central bank acts as a *lender of last resort* since there is no other institution in the country capable of meeting the demands.

How Central Banks Create Reserves If the commercial banks presenting paper for rediscount should take the proceeds in gold, silver, or Government-issued paper money, the central bank could do no more than make available the mobilized reserves which had been deposited with it. But in practice most of the proceeds from rediscounting are taken in the form either of notes issued by the central bank or of deposits in that bank. This practice permits the central bank, within the limits set by law, to *create* reserves in these two forms, and thus to augment the total of reserves available. This is the principal source of the central bank's power to influence monetary and credit conditions.

In acting as lender of last resort, the central bank should have some reserve of unused lending power

and also emergency power to suspend temporarily the ordinary limits of credit creation. Recognition of the central bank's responsibility as a lender of last resort began to develop a century ago and reached its full development in England in the 1870's. The underlying theory is that the only feasible way to meet a threatened money panic is for the central banks to grant accommodations freely but at a high, penalty rate. In that way urgent demands will be met but the high rate will force a contraction of total credit outstanding.

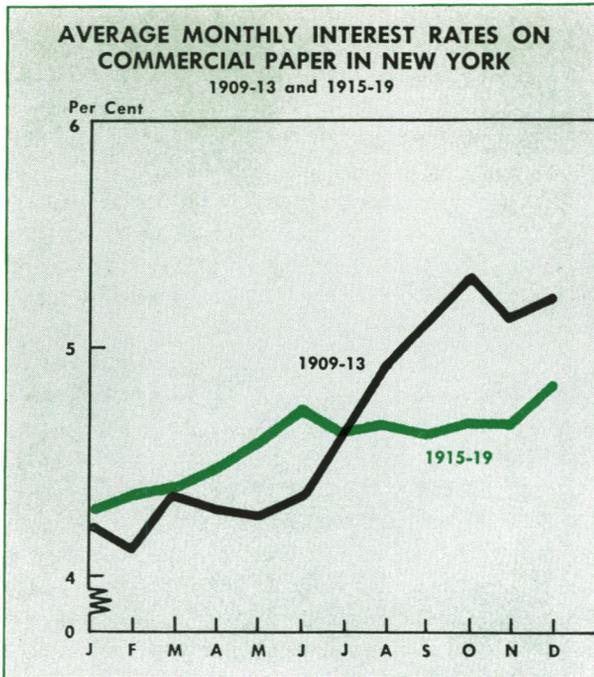
Until World War I, discounting was almost the only channel through which central bank funds were made available to the commercial banking system, although the Bank of England had started some elementary forms of open market operations by making occasional purchases of certain kinds of paper in the market. Such operations had not developed for two principal reasons. First, there were very few money markets in which they could be conducted. Second, many central banks did not have the statutory authority to engage in them, in many cases because of the recognized danger in allowing central banks to buy Government obligations.

The more efficient use of reserves under well-developed central banking systems made it possible for a given amount of reserves to support more bank lending and investing. In this respect the establishment of the Federal Reserve System was especially opportune and dramatic because money and credit markets had been badly disorganized by the outbreak of war in Europe. In its first *Annual Report* the Federal Reserve Board made these comments on the new reserve requirements:

"The change in reserve requirements . . . released, not only in New York but throughout the country, a very considerable amount of funds which had previously had to be held idle by the banks in order to bring or keep themselves within the requirements of the law. . . . the release of actual cash was very large and . . . the increase of lending power on the part of member banks was correspondingly larger. Member banks were thereby enabled to extend loans to their customers very much more freely, with a commensurate decline of discount rates as a consequence."

* * *

"The reduction of reserve requirements was only a part, however, of the beneficial effects of the new system. Appreciation of the fact that when the new lending power should all have been absorbed there would still remain the great credit potentialities of



the Federal reserve banks, furnished a basic element of confidence which helped to lower the abnormally high rate of interest that had existed.”

Another significant effect of the change was a reduction in the rather sharp seasonal fluctuations in interest rates. The accompanying chart shows that interest rates on commercial paper in New York fluctuated considerably less from month to month in the five years after the establishment of the Federal Reserve System than in the five years before that date.

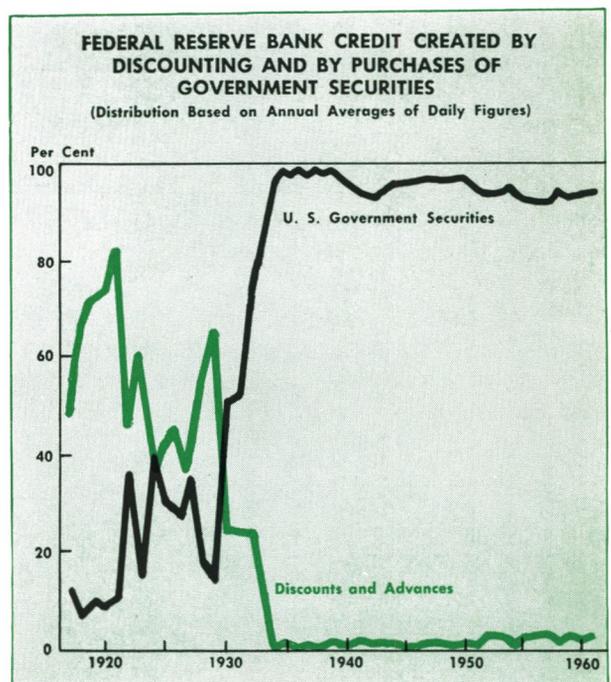
The discounting mechanism is used as a medium for the implementation of monetary policy by moving the discount rate up and down. An increase in the rate may have both a direct and a psychological effect. The direct effect is that it makes borrowing from the central bank more expensive and thus may cause banks to curtail their borrowing and reduce their willingness to lend. The psychological effect is that it is a signal to the business world that the central bank has embarked on a program of credit restraint and that further restraining moves may follow unless credit expansion slows down. A lowering of the discount rate has the opposite effects.

Limitations of Discounting Credit control through the discount rate represented a significant advance in banking theory and practice. In modern economies, however, situations frequently develop which require, on short notice, relatively large increases or decreases in bank reserves. The discount rate mechanism may not be able to provide such changes at the

time and in the amounts needed. Discounting is undertaken at the initiative, not of the central bank, but of borrowing banks. Hence, the central bank may see a need for more reserves but be unable to take the initiative in supplying them. Further, many banks are reluctant to borrow heavily and may reduce their discounting while there is still need for more reserves.

In open market operations central banks developed a tool to offset the above shortcomings. Accordingly, such operations have become the major tool of credit policy in most important financial nations. The accompanying chart shows how discounting and open market operations have changed in relative importance as the channels through which Reserve Bank credit was created in the United States. The discounting function declined in importance partly because central banks provided liquidity as needed through open market operations and partly because commercial banks have come to hold large amounts of short-term Government securities which can be sold when funds are needed.

Open Market Operations Open market operations consist of the purchase and sale of securities in the open market by the central bank. Almost always the securities are Government obligations and usually they are short-term. Such operations have been developed largely in the past 40 or 50 years. Originally they were regarded as supplementary to the discount rate and were used “to make the discount



rate effective" by creating conditions which encouraged the banks to borrow more or less. Later, and especially in the 1930's, they became the principal method through which bank reserves were varied. Outside of the United States and the United Kingdom, open market operations have developed quite recently and still are used as a major tool in only a very few countries—probably not more than eight or ten.

Open market operations constitute a direct and comprehensive instrument of credit control with a number of advantages. They enable the central bank to take the initiative and to affect directly both the amount of bank credit and the volume of bank reserves. Further, open market operations are very flexible in two ways. They can be used to produce very small or very large changes in reserves. Also, the direction in which they are used can be reversed quickly if conditions warrant. Finally, they can be employed without overt publicity if that is desired. But if publicity is desired it can be obtained by a change in the discount rate or by means of a public announcement.

Several conditions are essential for the successful conduct of open market operations. Of course, the central bank must have the necessary statutory powers and the necessary financial resources. In addition, there must be a large volume of Government securities outstanding and a broad, active, and well-organized market in those securities. This is essential because at times the central bank must engage in very large operations amounting, in the United States, to several hundreds of millions of dollars in one week. The market must be sufficiently large and active that such operations can be carried out without disrupting or upsetting the market and causing wide price changes. In practice, a large part of the outstanding securities must have short-term maturities because long-term securities are usually permanently placed in investment accounts and the trading in them is relatively "thin."

Since the above requirements are met in only a very few countries, open market operations are used as a major instrument in only a handful of nations. Other countries must continue to depend primarily on other means of control.

Changes in Reserve Requirements A comparatively new method of credit control is the changing of the reserve requirements of commercial banks. It was first authorized in the United States in the Banking Act of 1933, but since then has been copied by a number of central banks. An increase in requirements can wipe out existing excess reserves and even

create a deficiency of reserves, forcing commercial banks to discount with the central bank or sell short-term liquid assets. This should exert a definite tightening influence on the volume of bank credit. A reduction of requirements would ordinarily have the opposite effect.

This technique can be broad and sweeping, affecting immediately every bank to which the requirements apply. It has been looked upon as a blunt instrument and, until recently, has not been used for small, temporary reserve adjustments. Rather, it has been used chiefly to adjust to broad and apparently permanent changes in the total availability of reserves.

A variation of this technique is the system of "special deposits" used by a number of central banks. Under this system banks are required to lodge as special deposits with the central bank some specified percentage of the increase in their deposits over some time period chosen as a base. Used skillfully and firmly, this technique can remove much of the incentive of banks to extend credit and thus can be a powerful factor in stopping an inflationary growth of credit.

Still another related technique, much discussed but seldom used, is the power to require banks to maintain *secondary reserves*, usually in the form of Government securities, in addition to their primary reserves of cash and deposits in the central banks. Its purpose is to limit the amount of credit banks can extend to the private sector of the economy in the form of loans. One of its dangers is that it may create artificially favorable conditions and low interest rates in the Government securities market and thus encourage deficit financing by the Government.

Other Methods of Credit Control There are several other methods of controlling or influencing credit which are especially appropriate for smaller countries with relatively rudimentary money markets. One is *credit rationing*, in which the central bank sets a limit to the total amount of discounts it will accept or assigns quotas to particular banks or groups of banks. Another is *direct action*, in which the central bank acts to limit the interest rates, maturities, and purposes of the loans and investments which commercial banks may make. A substantial number of the central banks established in recent years have this power, usually stated in broad, loose terms. It has not been used extensively but it may be influential in making the banks give more heed to the statements, suggestions, and policies of the central bank. Such powers do not exist in the United States except in one respect. In 1933, Federal Reserve Banks and

the Board of Governors were empowered to deny discount privileges to any bank which has been excessive in financing speculation. Generally, central banks are averse to using control devices against particular banks or groups of banks because they are likely to cause friction and charges of discrimination.

Moral suasion, or "jaw-bone control" as it is sometimes called, is a device used occasionally by many central banks. It is the practice of "suggesting" policies which banks should follow. It may be used because the central bank finds it difficult or impossible to put together a combination of moves which will accomplish exactly the desired objectives or because it believes the end can be accomplished more smoothly by persuasion than by pressure. The effectiveness of such statements depends heavily on the prestige of the central bank and the extent to which the financial community believes that more powerful actions, if necessary, will follow the statements. They are likely to be relatively more effective in countries such as Canada and the United Kingdom in which a large part of the banking resources is concentrated in a few banks.

There is almost no limit to the areas or subjects which may be covered by moral suasion, but it must be used very carefully and very sparingly. Generally its effectiveness is likely to decline in direct proportion to the frequency of its use.

Publicity may be used as an adjunct to, or as a substitute for, moral suasion. In this case, the central bank endeavors to keep the banking system and the public fully informed about financial conditions and the general line of central bank policy. This is done in the hope that the banking system, from its analysis of conditions, will arrive at sound decisions as to the correct policy and will agree with the central bank's general position. If this should be true, then the banks would conclude that their own interests and the interests of the country as a whole would be best served by following the central bank's policy and would not require pressure to direct them in that direction.

INTEREST ON RESERVE DEPOSITS

Quite often commercial banks which keep their reserves with a central bank express dissatisfaction because they do not receive interest on such deposits. One view is that the central bank makes large profits through the use of such deposits and the depositing banks should, in equity, receive a part of those earnings. This complaint goes back at least as far as the first year of the Federal Reserve System. Limitations of space prevent any full treatment of this topic but a few pertinent points may be noted.

This view rests on a misconception about the nature of commercial and central banking. A commercial banker knows that if he gains additional reserves he can use most of them to expand his earning assets and, since he is in business for profit, he normally keeps his earning assets about as high as his reserves permit. He does not create the reserves; they come to him from cash deposited by his customers or through the clearing house.

A central bank, on the other hand, is not operated primarily for profit, and it usually does not expand its earning assets to the full amount permitted by its reserves. Further, the central bank, in practice, is not dependent on the reserves deposited by commercial banks in the same way as commercial banks are dependent on their reserves. The central bank acquires assets—discounted paper or investments—by creating liabilities against itself, initially in the form of deposits. Those deposits must remain in the central bank unless they are withdrawn in currency, in which case the central bank will almost certainly substitute its notes for its deposit liabilities, since the notes are legal tender. Conversely, when a commercial bank builds up its reserves at the central bank it does so by depositing currency or deposits which are liabilities of the central bank. Obviously, its own liabilities cannot function as reserves for the central bank.

In the absence of a central bank the commercial banking system must hold certain nonearning assets—gold or legal tender currency—as reserves. As we have seen, the total of those reserves is greater than the reserves needed under a central banking system. When a central bank is established and the commercial banks deposit their gold and currency reserves in the central bank, the commercial banks suffer no loss of interest since they merely exchange one nonearning asset for another. In fact, they gain because of the lower amount of reserves required. On the other hand, the central bank cannot increase its income when gold or legal tender is transferred to it. Indeed, it might experience a reduction of earnings. If the transfer were substantial, the central bank might have to sell earning assets in order to keep the bank reserves at the desired level.

The heart of the matter is that according to the principles under which central banks operate their earning power is not increased by the deposits which commercial banks carry with them, regardless of the way in which those deposits are created. Rather, the great profitability of central banks is due to the fact that they exercise the sovereign power of governments to create money.

FARM COMMODITY OUTLOOK

The following highlights of the national outlook for some of the farm commodities important in the Fifth District are based entirely on statements presented by economists of the U. S. Department of Agriculture to the 40th Annual National Agricultural Outlook Conference held in Washington, D. C., on November 13-16, 1962.



EGGS Egg prices late this year and early next year may be high enough to encourage a moderate increase from 1962 in the number of replacement chickens raised. Consequently, some increase in egg production may occur in 1963, and the average price for the year is likely to be somewhat lower because demand may decline further. Greater production in the second half of 1963 may tend to limit the seasonal climb in prices as compared with 1962.

FLUE-CURED TOBACCO The 1963 crop, up 9% from 1962, is greater than probable total domestic use and exports during the 1962-63 marketing year. Thus carryover stocks probably will show an increase for the first time in six years. Domestic use, which unexpectedly fell slightly in 1961-62, will likely rise somewhat in this marketing year. Exports may drop a little from the six-year high reached in 1961-62.

POULTRY The higher prices received by broiler and turkey producers in 1962 appear to have set the stage for a large expansion in poultry production in 1963. An upturn in broiler production is already well underway. In addition, turkey growers in October revealed plans to keep more breeder hens than a year ago. Broiler output may continue well above, and prices below, the 1962 level throughout much of 1963, particularly in the first part of the year.

SOYBEANS Exports, primarily to Japan and Europe, were a record 153 million bushels in 1961-62 and are expected to rise to 175 million bushels in this marketing year. Domestic crushings for oil and meal are forecast at a record 450 million bushels. Carryover stocks on October 1, 1963 may be around 60 million bushels, mostly in the hands of CCC. Prices will be linked closely to CCC price support operations, which will place a floor under the market this fall when marketings are at their peak. Later the CCC resale price probably will set the ceiling. The 1962 average is expected to approximate the \$2.28 per bushel received in 1961.

COTTON For the second consecutive year, the carryover of cotton is likely to increase—this year by over a million bales—because of a larger crop and smaller total demand. A decline of about 400,000 bales from last season's domestic mill consumption of 9 million bales seems indicated by recent reductions in mill activity and increases in the ratio of mill stocks to unfilled orders for cotton cloth. Exports are expected to be near last season's level of 5 million bales, but below the average of the past five years primarily because of record-high production in the foreign free world.

PEANUTS The 1962-63 outlook is for farm prices of peanuts to average around 11.0 cents per pound, about the same as last year. The 1962 crop of peanuts is well in excess of food and farm requirements. Farm prices, as in recent years, are likely to average near the CCC support rate, and CCC will acquire the surplus under the support program. Around 75 million pounds of the 1962 crop of 1,705 million pounds may eventually wind up in the CCC program to manufacture peanut butter for distribution to school lunches and needy persons.

FEED Supplies of feed grains and protein concentrates are down again, and demand is expected to continue strong. Domestic and export requirements in this marketing year will probably exceed production by about 14 million tons, reducing the expected carryover into 1963-64 to 57 million tons, as compared with a record 85 million tons in 1961. Total consumption in 1961-62 was a record 155 million tons and exceeded production for the first time in ten years. With increasing livestock numbers in prospect, domestic consumption is expected to increase further.

MILK In many respects the dairy outlook for 1963 is similar to 1962 experience. Milk production in 1962 increased over last year, and consumption ran far below supplies. Therefore, price support purchases were very large. This situation is expected to be repeated in 1963. However, the consumption picture is somewhat improved. Aggregate consumption of milk and dairy products is currently increasing, compared with a drop in 1961, and the prospect is for a further gain in 1963. Proposals for new dairy legislation are expected to be made to Congress in the coming year.

LIVESTOCK Improvement in lamb prices and slight decreases in cattle and hog prices are in prospect for 1963. Greater beef and pork production probably will more than offset declines in production of veal, lamb, and mutton. Total red meat supplies are expected to rise sufficiently to add about a pound to per capita consumption, raising it to 163.5 pounds. In the face of this probable increase in supply, the prospective gain in per capita income for next year appears insufficient to increase demand enough to maintain average prices at the 1962 level.

Flue-Cured Tobacco Makes News

Every fall about \$700 million passes from tobacco buyers to farmers in the flue-cured tobacco auction markets of Virginia and the Carolinas. Little wonder, therefore, that news from the markets is closely followed by businessmen in these areas. This year the reports were rather unsettling; the average market price was 4.5 cents per pound, or 7% below that of last year, and the average quality of the crop was very low. These developments have justifiably caused concern and have occasioned a critical re-examination of the Government flue-cured tobacco program, which in recent years has been a favorite example of successful supply control.

A review of the problem, which appears to have come to a head this year, supports two general conclusions about its causes and appropriate corrective actions. With respect to the drop in quality, it must be noted that in the last seven years there has been a marked narrowing of the difference between prices bid for tobacco of high and low quality. The market, in effect, has been telling farmers to produce more low quality tobacco. Since this incentive is a product of the market place rather than of the Government program, a reversal might well stem from market rather than Government action. Some enlargement of the price differential has apparently occurred in this year's markets.

Second, it appears that the market price has been adversely affected by output in excess of total domestic use and exports. As shown by the charts on the following page, the favorable balance between production and total use achieved by the acreage allotment reductions of 1957 has been gradually upset by rising yields per acre. Here corrective action clearly lies within the scope of the Government program. Such action may be directed either toward increasing use, as was done in 1959 by legislation which moderated the price-raising effects of certain provisions of the program, or toward reducing production by such action as the recent 5% cut in acreage allotments for 1963.

BACKGROUND In seeking reasons for the current events, a review of the recent past is helpful. In the early 1950's, both production and domestic use of flue-cured tobacco rose to levels considerably above those of preceding periods. Between 1952 and 1957, however, domestic use fell, primarily because of public concern about an alleged relationship between cigarette smoking and lung diseases. This concern contributed to both reduced cigarette production in 1953

and 1954 and increased popularity of filter cigarettes, which use less tobacco per cigarette.

Despite this decline in tobacco consumption, production increased. Acreage allotments were cut, but yields per acre rose and the 1955 and 1956 crops were lower in quality and especially large, about one-seventh greater than total domestic use plus exports. During these years prices received by farmers were maintained near their previous level by the Government price support program. The spread between the average support price and average auction price narrowed from 4.9 cents per pound in 1953 to 2.6 cents in 1956, and growers placed about one-fifth of the 1955 and 1956 crops under Government loan.

The experience of these two years led to a sharp downward adjustment of flue-cured acreage allotments in 1957, and production in that year was 203 million pounds below total domestic use plus exports. In response to this new imbalance and to improved prospects for cigarette consumption, the average price received by farmers rose by almost 4 cents per pound.

The market price rose again in 1958, partly as a result of upward revision in the average level of price supports. Under legislation in effect prior to 1960, the average support level had to be increased immediately whenever prices paid by farmers rose. Such adjustments, totaling 7.6 cents per pound, were necessary in the 1954-59 period. A 1960 revision in the price support law, however, provided for more gradual changes in the support level after any future rise in the prices of farmers' purchases. Under the revised law, the average support remained at the 1959 level of 55.5 cents per pound in 1960 and 1961 and increased by only 0.6 cents in 1962.

During these years, it was also necessary to revise periodically the price support established for each of the many kinds and qualities of flue-cured tobacco produced. In general, the Government's policy has been to adjust the support for each grade in accordance with the trend exhibited by the auction price for that grade. Thus the adjustments have lagged considerably behind the price changes. In addition, the law required that the average support price for the crop be maintained even if the composition of the crop shifted, as it actually did, toward the lower priced grades. In practice a ten-year average has been used as the reference for the grade composition of the crop, and thus again the support adjustments have lagged behind the events requiring them. In 1961, however, it was found necessary to

raise support prices by grades an average of 2.4 cents per pound in order to maintain the crop average at the lawful level. This type of change does not show up in the average support level shown on the chart.

WHY LOWER QUALITY? Awareness of the lags just discussed is important in an analysis of the relationship between the Government program and the trend toward lower quality in the crop. The primary factor that has allowed farmers to pay less attention to quality is the increase in prices paid for these grades, and much of this price rise has occurred independently of the Government program. The public's shift toward filter cigarettes requiring stronger flavored tobacco and the development of manufacturing processes able to utilize more stems and poorer grades have increased domestic manufacturers' demand for the lower priced grades. As a result, the price difference between qualities classified by the USDA as "poorer" and "better," which was about 20 cents per pound in 1955, narrowed to about 10 cents by 1961. Another result was that the Government was able to sell most of its holdings of poorer quality tobacco and by this summer its stock consisted mainly of the higher priced grades.

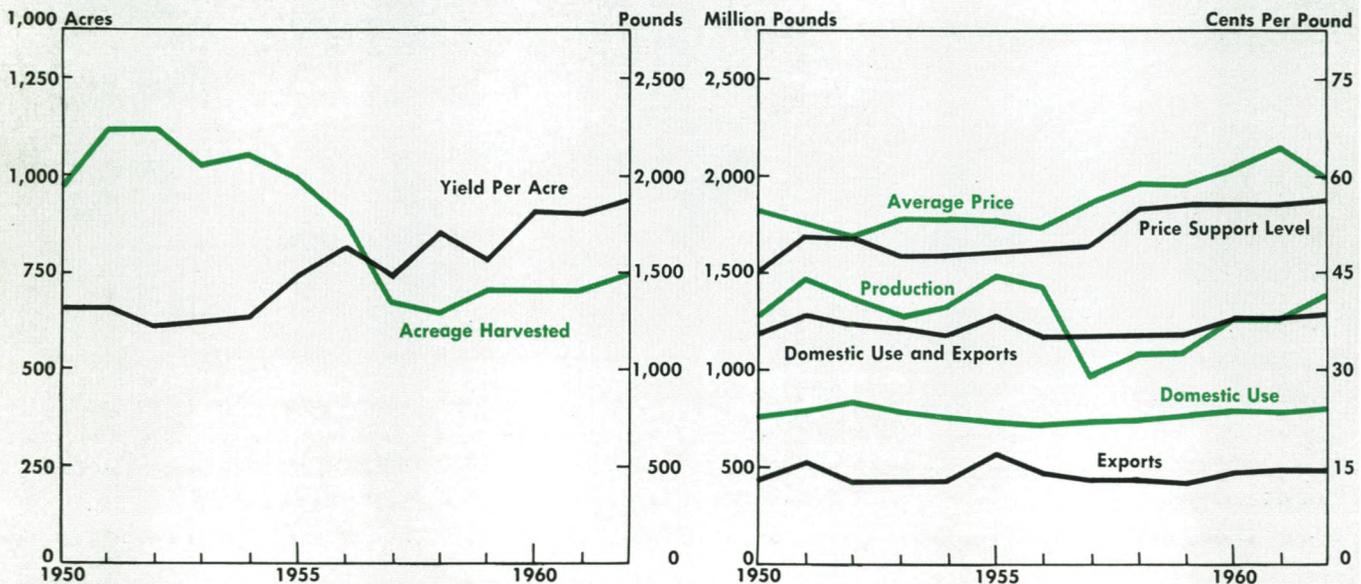
It pays farmers to sacrifice quality if doing so will raise yields by more than enough to compensate for the lower price received. If the present relationship of prices and qualities provides incentive for this course of action, it would continue to do so even in the absence of a Government program. It is significant to note that this incentive has been diminished by this year's price drops in the poorer grades, and that it has been shown that high yields of high quality

tobacco can be produced by following recommended cultural practices.

CURRENT SUPPLY-DEMAND In 1960 and 1961, increased production resulting from rising yields per acre almost closed the gap between production and total domestic use plus exports even though the latter increased significantly. Despite this experience, auction market prices increased sharply in both years. The spread between the average support level and the average market price increased from 2.8 cents per pound in 1959 to 8.8 cents in 1961.

Against this background, three developments in 1962 apparently contributed to price weakness. First, while exports rose to a six-year high in the year ending July 1, prospects in foreign markets became cloudy because of a cancer scare in England, relatively unfavorable tariffs levied by the European Common Market, and uncertainties associated with England's entry into the Common Market. Second, domestic cigarette production in the same marketing year rose by only 2% as compared with increases of 3% to 4% in most years since 1956, and domestic use of flue-cured unexpectedly dropped slightly as the trend toward less tobacco per cigarette apparently continued. Third, production rose by 9%, partly as a result of a 4.3% increase in acreage allotments, and therefore, stocks at the beginning of the next season are expected to show an increase of about 90 million pounds over a year earlier, the first rise in the carry-over since 1957. Thus the price drop this fall probably also reflected the newly emerged imbalance between supply and demand under the present provisions of the Government program.

FLUE-CURED TOBACCO UNITED STATES, 1950-1962



Notes: Domestic use and exports are shown for years beginning July 1. Data for 1962 are estimated.
<http://fraser.stlouisfed.org/>
 Federal Reserve Bank of St. Louis

THE FIFTH DISTRICT



Like the proverbial young speaker with fervor in excess of experience, business has recently created an impression of "riding off in all directions." General business sentiment both nationally and within the borders of the Fifth District clearly seems more buoyant, more optimistic, than was the case just a few weeks earlier. Yet only limited evidence to support a more cheerful outlook can be gleaned from that old cold turkey, the statistical record. Since most statistics are several weeks late when published, it is always possible that current conditions really are better than the record of the recent past.

DISTRICT MAY BE LAGGING Certain broad indicators of District business have declined recently and compare less favorably with national statistics. The District's seasonally adjusted count of nonfarm jobs, at an all-time high in September, dropped slightly in October. National employment, on the other hand, rose to a new high surpassing by a small margin the previous peak recorded in July. District seasonally adjusted factory man-hours also receded, but in circumstances apparently more serious than those attending the drop in employment. The October reduction in man-hours was the third in a row and amounted to fully 1%. National man-hours also declined in October, but the loss was smaller and followed a September gain.

Seasonally adjusted retail sales rose 2% nationally in October, but a comparable District figure is not available. Sales of department stores in that month, however, fell short of usual seasonal strength in both the District and the nation. Seasonally adjusted department store sales in October dropped 9% in the District and 6% in the nation following good gains in each month since June. October trade employment reflected approximately seasonal strength in both District and nation.

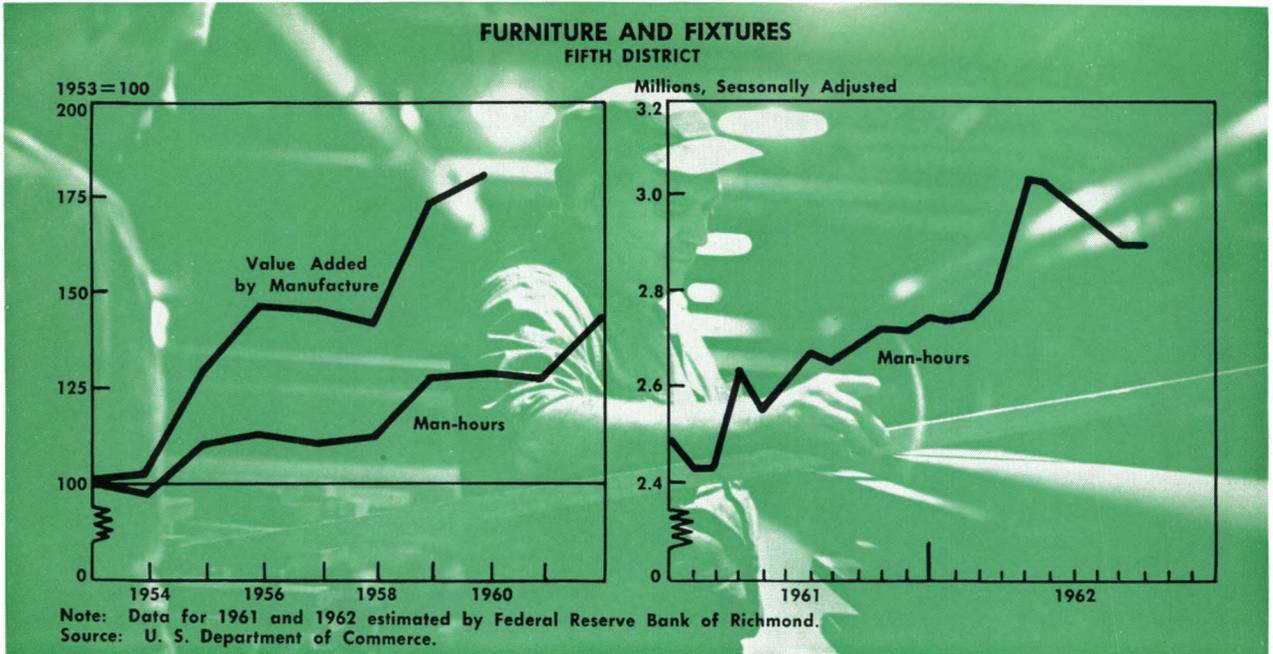
CONSTRUCTION PICTURE DIFFERENT On the basis of rather sketchy evidence, construction appears to be the only major area that may currently be stronger in the District than in the nation as a whole. Construction employment rose in the District during October while declining nationally. Construction jobs in the District, seasonally adjusted, reached a

peak for recent years in August and moved up close to the peak again in October. For the nation the number of construction workers, seasonally adjusted, reached the current year's high in July and has declined steadily since. Contract awards have been declining unevenly in the nation since March and in the District since April.

SLOWER PACE IN TEXTILES, TOBACCO Most areas of District manufacturing were affected by October reductions in man-hours. The exceptions were transportation equipment, lumber, furniture, food, and paper. Of particular significance are the declines that have recently occurred in two classes of non-durables: the textile and apparel group because of its size and complexity, and tobacco manufacturing because of certain fundamental changes that seem to be in the making.

Textile and apparel factories accounted for 34% of all District man-hours in October and were responsible for 49% of the total October decline. Textile man-hours reached their 1962 high in May, apparel man-hours in June. Both have declined steadily since. Mild strengthening of textile demand earlier in the fall failed to develop into any sort of general recovery. Prices have weakened slightly and profit expectations, quite rosy only a few weeks ago when a strong seasonal upswing seemed imminent, have assumed a shroud of uncertainty again.

The explanation and probable duration of current cigarette trends are also matters of considerable uncertainty. Cigarette production has grown quite steadily year by year since 1954 when the effects of the original "cancer scare" apparently wore off. But after annual increases of around 5% per year in the late 1950's, the growth of District cigarette production slowed to 4% in 1960 and 3% in 1961. Output so far this year is running only 2% ahead of 1961. With productivity rising, man-hour gains were small in 1960 and 1961. Man-hours in cigarette manufacturing are actually 1% lower on a ten-month cumulative basis than they were a year ago. Cigarette factory man-hours seasonally adjusted, after declining quite steadily from a peak in April, leaped to the year's high in September and then dropped 11% in October to one of the lowest levels of recent years.



FURNITURE PROSPERITY CONTINUES The first furniture chart at the head of the page shows recent trends in annual man-hours and value added. The second shows the pattern of recovery in monthly man-hours since the February 1961 business cycle low. Rising productivity is clearly apparent in the first of these charts. Based on 1953 as 100, a 29% rise in man-hours by 1960 was accompanied by an 80% increase in value added. Value added per man-hour rose from \$2.55 to \$3.56, failing to increase only during the recession years of 1957 and 1958. After adjustment for a 10% price rise the 1960 figure for value added per man-hour comes to about \$3.24, still an impressive improvement for a period of only seven years. The first chart also shows a sharp man-hour increase over last year that strongly suggests record levels of production and sales for the District furniture industry in 1962.

The second chart, however, raises some questions about the direction of the furniture industry's current fortunes. During the second half of 1961, while the man-hour total for all manufacturing moved 1% downward, furniture man-hours moved nearly 3% upward. When all factory man-hours began to rise again early this year, furniture man-hours shot up 11% to a peak in April. Since then the trend in furniture man-hours (and in man-hours generally) has been downward. Although total factory man-hours continued to decline in September and October, furniture man-hours remained virtually unchanged. This drop in furniture man-hours between April and August warrants some rationalization.

The build-up of furniture demand began in the fall of 1961 when furniture sales soared in all parts of the country, and the seasonally adjusted index of District furniture store sales equaled record levels dating back to the spring of 1956. Buyers continued to keep channels of distribution busy, and the District sales index reached a new high in April. The spring furniture market brought a veritable flood of orders to many District producers whose backlogs were already unusually good. In retrospect it appears almost certain that the April increase in production was so much larger than the normal seasonal gain that the "seasonally adjusted" declines which followed represented a return to normal levels of growth rather than any actual loss of strength in this furniture cycle. The fall markets in October brought another wave of new orders, and the levels at which furniture man-hours stabilized in September and October appear to be consistent with the line of growth established last year.

Many new lines of furniture introduced this year were exceptionally well received. But new styles were far more numerous than usual, and some were left at the post. On the basis of this year's experience, District furniture makers feel that they can keep the number of new models at a minimum in 1963 and still have a very good year.

PHOTO CREDITS

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