

MONTHLY



# Review

**FEDERAL RESERVE BANK  
OF ST. LOUIS • P. O. BOX 442 • ST. LOUIS 66, MO.**

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# Current Economic Developments

## Business Conditions

**I**NVENTORY LIQUIDATION by businesses in July and probably in August as well slowed the pace of business activity. The industrial production index in August, at 109 per cent of the 1957 average, was slightly below its March-July level and was 2 per cent below the peak reached last January. Output of materials and consumer goods changed little, and output of equipment remained about constant. Manufacturing employment declined between mid-July and mid-August, after seasonal factors are taken into account. Unemployment, on a seasonally adjusted basis, rose to 5.9 per cent of the civilian labor force. The number of unemployment compensation claims continued to rise in late August, suggesting continued slackness in labor markets.

The turn from inventory accumulation to inventory liquidation in manufacturing had been foreshadowed for several months by the efforts of steel users to work off excess stocks and by a gradual decline in manufacturer's new orders for durable goods. New orders for durable goods in July, after seasonal adjustment, were 2 per cent lower than in June and were below the level of sales for the eighth consecutive month.

How far the inventory liquidation will go depends upon the state of final demand for goods. Although

consumer spending has remained stable at a relatively high level, it has not increased as much so far this year as had evidently been expected by some manufacturers, in particular the makers of major household appliances. Manufacturing of appliances and parts is a major activity in several Eighth District areas.

A continuing decline in residential construction has weakened demand for lumber, another major Eighth District product. Expenditures for private residential building in the nation in August were 16 per cent below the year-earlier rate. Residential construction contract awards in the Eighth District's five largest metropolitan areas combined were 25 percent less in total value during the first seven months of this year than in the same period of 1959.

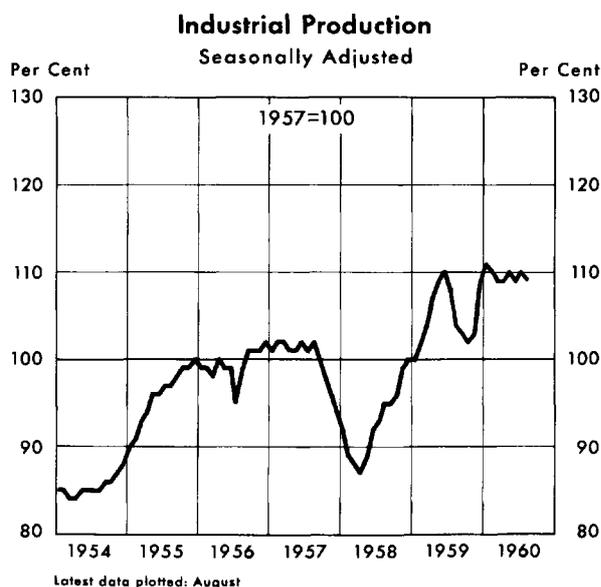
The most recent Department of Commerce-Securities and Exchange Commission survey of business plant and equipment expenditures indicates a leveling off in planned business outlays for fixed capital in the second half of the year, at a rate somewhat lower than had been indicated by earlier surveys. Government outlays, however, at both the Federal and the State and local levels, are continuing to rise.

## Federal Reserve Actions

During August and early September discount rates were lowered at all Federal Reserve Banks from 3.5 per cent to 3.0 per cent. The lower rate became effective at the Federal Reserve Bank of St. Louis on August 19. This is the second time this year that the Federal Reserve Banks have lowered their discount rates; in June the twelve Reserve Banks decreased their rates from 4 per cent to 3½ per cent.

On August 8, the Board of Governors amended Regulation D, which relates to member bank reserves and reserve requirements, in three ways.<sup>1</sup> These actions made available to member banks approximately \$600 million of additional reserves. Although these changes were made in anticipation of greater seasonal credit needs in the fall, they implemented an Act of Congress, passed July 28, 1959, which affects vault cash and reserve requirements.

<sup>1</sup> See "Changes in Member Bank Reserve Requirements," in August 1960 issue of this *Review*, pg. 7.



The Act authorizes the Board of Governors to permit member banks to count part or all of their vault cash as reserves in addition to their balances with Federal Reserve Banks. This action was presumably taken to correct an inequity which arose because some banks, particularly country banks, required larger amounts of vault cash for operating purposes than other banks. It also provides for the abolition of the classification "central reserve city" by July 28, 1962. The Act increases from 20 to 22 per cent the maximum reserves that reserve city banks may be required to maintain on net demand deposits. It reduces from 26 to 22 per cent the maximum reserves and from 13 to 10 per cent the minimum reserves that the central reserve city banks may be required to hold to make them the same as the maximum and minimum requirements for reserve city banks. In addition, the Act authorizes the Board of Governors to classify banks in central reserve cities as reserve city banks or country banks and banks in reserve cities as country banks if their business resembles the business of banks in the lower classifications more than that of banks in their geographical location.

The recent amendments to Regulation D liberalized the proportion of vault cash member banks can count toward meeting their reserve requirements. Country banks are now permitted to count vault cash in excess of 2½ per cent of demand deposits as part of their reserves instead of the 4 per cent set last December 1. Central reserve city banks and reserve city banks are now allowed to count vault cash in excess of 1 per cent instead of 2 per cent of demand deposits in meeting their reserve requirements.

As a step toward eliminating the differential in reserve requirements on net demand deposits between central reserve city banks and reserve city banks, the amendments to regulation D reduced the requirement for central reserve city banks from 18 per cent to 17½ per cent. This action reduces the differential from 1½ percentage points to 1 percentage point. The requirement for reserve city banks is now 16½ per cent.

It has been estimated that these changes which became effective August 25 for country banks and September 1 for central reserve city and reserve city banks will make available about \$600 million of additional reserves, \$480 million through the change in the vault cash requirement and \$125 million arising out of the reduction in reserve requirements for central reserve city banks.

In addition to lowering discount rates and providing more reserves through vault cash and reserve require-

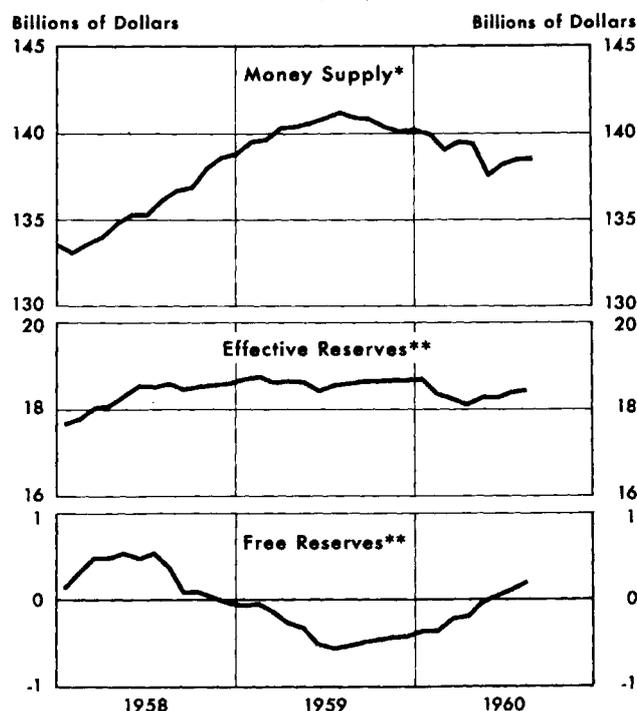
ment changes, the System added funds through open market operations in recent weeks. Open market operations, that is, buying assets, primarily Government securities, in the market and paying for them with reserves or selling assets for reserves, have been the primary tool of monetary actions. These actions which are conducted on an almost daily basis usually receive little attention in the press. From the week ended July 27 to the week ended September 14, average System holdings of securities rose about \$55 million, adding a like amount to member bank reserves. About \$2 million represented outright purchases of Treasury bills, \$48 million was in the form of purchases of Government securities with an agreement by the seller to repurchase within a short period of time, and the remainder, about \$5 million, was net purchases of bankers' acceptances. These reserves were more than offset, however, by money market drains, chiefly gold outflows, a Labor Day flow of currency into circulation and a contraction in float (central bank credit extended on checks in process of collection). Member banks also reduced their borrowed reserves \$52 million in the period.

### Total Effective Reserves

In the first two weeks of September, total effective reserves of member banks, seasonally adjusted, rose

### Money & Bank Reserves

Seasonally Adjusted

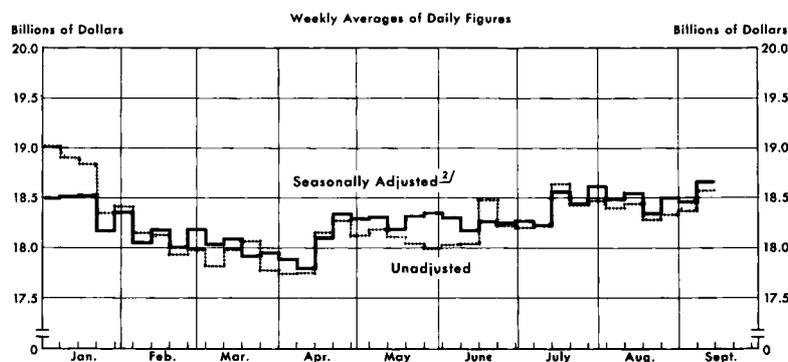


\*Last Wednesday of Month

\*\*Monthly Averages of Daily Figures

Latest data plotted: August preliminary

### Total Effective Reserves of Member Banks <sup>1/</sup>



<sup>1/</sup> For data previous to September 1, figures are total reserves less \$125 million for estimated change in reserve requirements. Data after September 1 are total reserves.

<sup>2/</sup> Seasonal adjustment factors were obtained roughly by averaging daily figures for each calendar day for the five years 1955-59. These were divided by the average level for the entire five years. The seven calendar date factors were then averaged to obtain the weekly factors. Unadjusted data were divided by weekly average factors to obtain the seasonally adjusted data.

after drifting lower during August (See chart).<sup>2</sup> Reserves of member banks declined from early in January to mid-April. There was a large rise in April and since this time reserves have increased only moderately in an irregular fashion. Total effective reserves averaged about \$18.5 billion in early January, reached a low of about \$17.8 billion during the first few weeks of April, and averaged about \$18.4 billion in recent weeks.

The decline in total reserves since the first of the year has resulted primarily from a substantial decline in member bank borrowing. Member bank borrowing which averaged about \$950 million in early January has declined almost continuously to an average level of about \$290 million in the five weeks ending September 14. As a result, free reserves, the difference between excess reserves and borrowings, have gone from minus \$360 million in January to plus \$350 million in the five weeks ending September 14.

### Bank Credit and the Money Supply

According to preliminary data, commercial bank credit expanded slightly in August but at a lower rate than during July. Loans expanded moderately while investments remained about unchanged. Total bank credit has been rising since April after declining moderately during the first quarter.

<sup>2/</sup> Effective reserves are defined as total reserves adjusted for changes in reserve requirements. These adjustments are made in order to make total reserves of member banks comparable between periods in which changes in reserve requirements have taken place.

Reflecting the rise in bank credit, the money supply increased slightly during August. The money supply which declined almost steadily from July 1959 through May of this year has now risen in each of the last three months. The rise has been small and as a result the quantity of money is still below the April 1960 level.

The turnover of demand deposits at the 337 reporting centers outside the seven largest financial centers rose in August after declining during July. The velocity of money on a three-month moving average basis rose steadily from mid-1958 to March 1960. Since March the velocity of money appears to have leveled off.

### Interest Rates

There were divergent patterns in the movement of interest rates during August and early September. Yields on Treasury bills rose, although still well below the rates in existence during the first few months of 1960. Interest rates on long-term Government bonds rose slightly during August and early September. In contrast, yields on corporate bonds declined rather significantly in this period.

In early August when the discount rate was still 3.5 per cent, three-month Treasury bills were yielding 2.2 per cent. The reduction in the discount rate to 3.0 per cent brought this rate more nearly in line with other short-term rates, thereby increasing somewhat the effectiveness of open market operations in affecting total reserves. Even with the recent rise in short-term bill rates, the discount rate remains about .40 percentage points above the three-month bill rate. In comparison, this spread averaged .17 percentage points from 1951 through 1959. Therefore, despite the 1 point reduction in the discount rate since June, commercial banks as a whole may find it more advantageous to use additional reserves gained through Federal Reserve net purchases of Government securities to repay their borrowings from the central bank rather than as a base to expand bank credit.

# The Discount Mechanism and Monetary Policy

**T**HE PRIMARY OBJECTIVES of the Federal Reserve System are to provide monetary conditions that will facilitate economic growth, a high level of employment, and price stability. The System's ability to contribute toward these objectives rests, in large measure, upon affecting the money supply. To this end, the Federal Reserve depends chiefly on its ability to affect member bank reserves which in turn affect the quantity of bank credit and money. The proximate objective then is to influence, at any given time, the volume, cost, and availability of bank reserves in such manner as to promote the primary objectives noted above.

In order to regulate member bank reserves the Federal Reserve authorities have three major instruments—open market operations, discount rate changes, and changes in reserve requirements. During the period June-August the System made net open market purchases of about \$730 million, lowered the discount rate at most Federal Reserve Banks in two steps from 4 per cent to 3 per cent, and made adjustments in reserve requirements and vault cash which were expected to make available about \$600 million of reserves. As a result, total reserves of member banks expanded and the cost of borrowing additional reserves from the Reserve Banks was reduced.<sup>1</sup> Of all these actions taken by the System, the change in the discount rate probably received the most attention, while the change in reserve requirements was noted mainly in official and banking circles and the public remained relatively unaware of the direction of open market operations. This concern with movements in the discount rate arises because such changes are viewed by many as an indication of a change in Federal Reserve policy. This article attempts to analyze the role of discount policy in relation to overall monetary actions and thereby place changes in the discount rate in perspective.

Member banks obtain additional reserves from time to time by borrowing from their Reserve Bank. Typically, a member bank will borrow from a Federal

Reserve Bank in order to avoid a temporary reserve deficiency arising from an unexpected drain in its deposits. The individual bank has several means by which it can obtain additional reserves. It may dispose of assets (usually a short-term marketable security such as Treasury bills), borrow in the Federal funds market, borrow from a correspondent bank, or borrow from the Reserve Bank.<sup>2</sup> The decision as to which form the adjustment will take is influenced to a large extent by policies and actions of the System.

The primary function of the Federal Reserve System under the original act of 1913 was to provide for a more elastic currency. As originally conceived the discount mechanism was to be the major instrument of this policy. Member banks were permitted to discount notes, drafts, and bills of exchange of relatively short maturity arising out of actual commercial and agricultural transactions. Three years later Government securities were added to the list of eligible paper. During the 1930's, when member banks had large excess reserves, the discount mechanism assumed primarily a standby significance.

During the war and until the Treasury-Federal Reserve "accord" in 1951, member banks made their short-run reserve adjustments chiefly by buying or selling Government securities rather than borrowing from the Federal Reserve. In this period banks held large quantities of these securities, the prices of which were supported by the Federal Reserve.

After the accord, member banks once again began to rely more frequently on the discount mechanism to make short-run reserve adjustments. During this period the amount of outstanding borrowing rather closely paralleled fluctuations in the level of economic activity. Member bank borrowing reached peak levels in the months of December 1952, April 1956, and August 1959. Borrowings were lowest in this period

<sup>2</sup> The Federal funds market consists of the borrowing and lending, primarily by member banks, of deposit balances at the Federal Reserve Banks. For a more complete discussion of this institution see "The Federal Funds Market," in the April 1960 issue of this *Review*.

<sup>1</sup> See "Recent Financial Developments" in this month's *Review*.

during the months of July 1954 and July 1958. These dates correspond roughly to the peaks and troughs of business cycles since 1951.

Table I  
MEMBER BANK BORROWING  
Selected Months  
(Monthly averages of daily figures.  
In millions of dollars)

April 1951 .....	161
December 1952 .....	1,593
July 1954 .....	64
April 1956 .....	1,060
July 1958 .....	109
August 1959 .....	1,007
August 1960 .....	293

### Discount Policy

Discount policy at any time consists primarily of two aspects: administration of the "discount window" and setting the discount rate.

#### *Administration of the Discount Window*

The twelve Reserve Banks administer the function of lending to member banks in their respective districts as well as setting the rate which is subject to approval by the Federal Reserve Board. The principles used by each Reserve Bank in judging an application for a loan are set forth in Regulation A of the Board of Governors which reads in part as follows:

Federal Reserve credit is generally extended on a short-term basis to a member bank in order to enable it to adjust its asset position when necessary because of developments such as a sudden withdrawal of deposits or seasonal requirements for credit beyond those which can reasonably be met by use of the bank's own resources. . . . Under ordinary conditions, the continuous use of Federal Reserve credit by a member bank over a considerable period of time is not regarded as appropriate.

In considering a request for credit accommodation, each Federal Reserve Bank gives due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally. It keeps informed of and takes into account the general character and amount of the loans and investments of the member banks. It considers whether the bank is borrowing principally for the purpose of obtaining a tax advantage or profiting from rate differentials and whether the bank is extending an undue amount of credit for the speculative carrying of or trading in securities, real estate, or commodities, or otherwise.

Administration of the discount privilege does not change with shifts in monetary policy. The Reserve Banks are aided in their enforcement of Regulation A by the traditional reluctance of some commercial banks to remain indebted.

### *The Discount Rate*

The discount rate is the interest rate charged by the Reserve Banks on loans to member banks. This then becomes the cost of obtaining additional reserves through such borrowing. As brought out above a member bank has several alternatives in adjusting to short-run changes in its reserve position. The decision as to which method is adopted is determined in large part by the relative cost. The relative cost is frequently determined by 1) the loss or gain realized on the sale of a short-term earning asset, and 2) the relation between the discount rate and other short-term money market rates.

Insofar as an individual member bank is concerned, an adjustment in its reserve position through any of the alternative methods stated above solves the bank's immediate problem. From the standpoint of monetary policy the type of reserve adjustment is important. Adjustments in reserves which are made through transactions in the Federal funds market or in Treasury bills represent merely a transfer of funds. No reserves are created or destroyed in this process. On the other hand, borrowing or the repaying of borrowing from the Reserve Banks increases or diminishes total reserves of the banking system. As we have seen, this is the variable upon which the System operates in order to affect bank credit.

Open market operations have been in recent years the primary means through which the Federal Reserve exercises control over member bank reserves. Changes in borrowing from the Reserve Banks, which are at the initiative of the individual member banks, may offset temporarily the effects of open market operations. However, since the discount rate has an influence on the decisions of member banks either to borrow from the System or make their temporary reserve adjustments in some other way, the relationship of the discount rate to other market rates may tend to cause member bank borrowing in the aggregate to supplement, rather than offset, open market policies.

The following set of examples are designed to show how discount policy combined with open market operations function first in a period when the Federal Reserve is attempting to exercise credit restraint, and then again in a period of credit ease. It will be assumed in both cases that the banking system is initially in a state of equilibrium. That is, total bank credit is at a desired level and excess reserves and borrowings from the Reserve Banks are at levels which the member banks consider satisfactory. In addition we will assume that the economy is operating at a relatively high level and experiencing growth with prices about stable.

**Example 1—Credit Restraint.**

Assume for the moment that the demand for bank credit increases and that interest rates and prices are tending to creep up, and that the System would decide that supplying additional reserves via open market operations to meet this credit demand would be inflationary. As the demand for credit increases, member banks will seek additional reserves by selling securities or borrowing from the Federal Reserve. As short-term interest rates rise relative to the discount rate, banks will find it more desirable to adjust their reserve positions by increased borrowings from the System rather than by selling Treasury bills. As a result commercial bank credit would expand—new reserves being supplied by the System in the form of additional loans to member banks.

In order to slow up the rate of increase in member bank reserves, the System might reduce its open market purchases or allow market forces (gold outflows, cash drainage, or a rise in Treasury balances) to pinch reserves. Commercial banks would now find that in order to avoid reserve deficiencies it becomes neces-

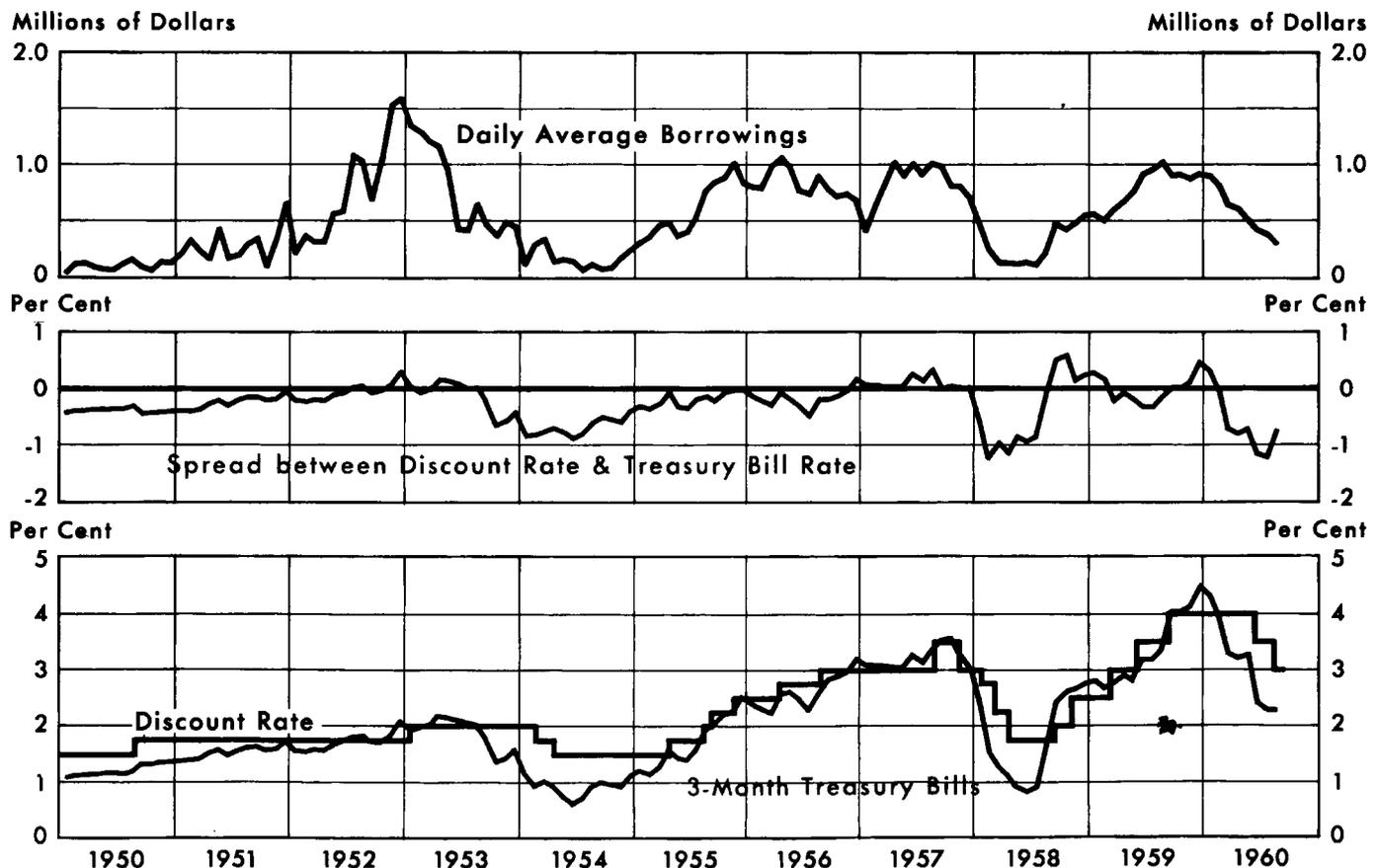
sary to further increase their indebtedness to the Federal Reserve. Although the intent of the System is to restrain the credit expansion, it will permit the use of the discount window to cushion the shock of reserve stringency for individual banks. In this sense the discount mechanism will act as a safety valve.

It should be recognized that the increase in member bank borrowing will offset initially the objectives of open market policy oriented toward restraint. To make this borrowing more costly and reduce the incentive to use the discount window the System may raise the discount rate. It may be noted that the Federal Reserve policy of restraint is already underway. The rise in the discount rate is not a signal initiating a change in policy as much as it is a move to strengthen a policy already in effect.

**Example 2—Credit Ease**

Starting once again from our assumed initial position, let us consider what happens if the demands for credit begin to slow up or contract, market interest rates are falling, and the possibility of a weakening

**Borrowings,\* Discount Rate & Treasury Bill Rate**



\*Member Bank Borrowings from Federal Reserve Banks  
 Latest data plotted: August preliminary

in economic activity appears. The banking system will probably find itself with more than the desired level of borrowing and may begin to repay borrowings from the Federal Reserve. The Federal Reserve with a view to encouraging full use of resources may supply reserves through open market purchases of securities. As interest rates continue to fall relative to the discount rate, banks would have an added incentive to repay their debt to the Reserve Banks rather than use their reserves for lending or investing. Thus, despite Federal Reserve action to increase reserves, the decline in outstanding borrowing may actually reduce reserves and total bank credit. In order to reduce the incentive to make further adjustments in reserves through repayment to the System the discount rate might be lowered. Here, again, the change in the discount rate cannot be considered as signalling a change in Federal Reserve policy, but rather a move designed to reinforce open market operations. The marginal advantage of the new-found reserves now rests with expanding investments or loans. Thus, the reserves made available to banks as their loans decline will be used to expand investment holdings when the discount rate is lowered relative to other money market rates. If investments increase more than loans decline, total bank credit and the money supply would tend to rise.

As has been pointed out in the examples above, discount rate changes can be used to keep changes in member bank borrowing from adversely affecting open market operations. Appropriate discount rate policy may be used to supplement open market operations as well as providing a safety valve. In practice, a major difficulty in implementing discount policy is to maintain the discount rate in proper relation to other short-term rates, primarily Treasury bills.

The Federal Reserve may not find it feasible to adjust the discount rate to maintain the desired relationship between it and other rates, for reasons relating to Treasury financing, sudden changes in short-term interest rates, and public reaction to discount rate changes. Thus, it is possible that with infrequent discount rate changes, the movement of other rates can alter the effectiveness of a given discount rate. In periods of boom with rising interest rates, a constant or "lagging" discount rate would provide the same incentive to member bank borrowing as a reduction in the discount rate with other rates unchanged. Similarly, in periods when credit policy is oriented toward ease a discount rate which lags behind the fall in market rates increases the "effective" cost of member bank borrowing, thus inducing a decline in member bank borrowings (reflected in a greater reluctance

to borrow and a stronger incentive to use excess reserves to repay outstanding borrowings). In such situations the discount rate tends to reduce the effectiveness of the open market operations designed to encourage credit expansion.

In light of the above analysis, many of the discount rate changes made by the Federal Reserve System may be considered as "technical adjustments" to market rates reflecting the efforts of monetary authorities to establish a relationship between the discount rate and other market rates appropriate for the effective accomplishment of the objectives of open market operations.

In recent years, among the numerous proposals providing for some modification in the operations and policies of the Federal Reserve System, are those relating to the discount mechanism. Several of the better known proposals are listed below.

### **Alternative Methods**

1. One alternative which has been advocated would eliminate all discretion associated with discount rate policy. This plan involves tying the discount rate automatically to a particular short-term money market rate. The Treasury bill rate usually is recommended for this purpose. This procedure would eliminate the possibility of the discount rate becoming out of line with the Treasury bill rate and would still retain fully the safety valve advantages of discounting. Since 1956 the Canadian central bank has followed this procedure by setting its discount rate each week at  $\frac{1}{4}$  of one per cent above the latest average tender rate for Canadian Treasury bills.

There are three primary arguments against such a technique. First, no one market rate is really "ideal" as a guide and if it happens that the bill rate becomes out of line with other short-term rates this would automatically place the discount rate out of line also. Second, there is no general agreement even among the advocates of this plan as to the frequency with which the discount rate should be changed. Many argue that weekly changes generate too much uncertainty. If a longer period is adopted, such as a month, lags in the discount rate as against other rates become an increasing problem. Third, fixing the discount rate in a set relationship with the bill rate eliminates the possibility of actively changing the discount rate to contribute to economic stability by supplementing open market operations.

2. Another alternative is an adaptation of the method described above which would eliminate the last criticism. This plan would tie the discount rate to the bill rate but would allow the spread between the two to vary with changes in monetary policy. The discount rate may be placed below or above the Treasury bill rate, depending upon the degree of ease or restraint the System wished to follow. The spread between the two rates would not vary with changes in the bill rate but would be changed only in response to a change in Federal Reserve policy. The advantages claimed for this procedure are that technical adjustments would be made automatically and any change in the spread would be associated with a definite change in monetary policy. This would eliminate any doubt as to whether a given change in the discount rate represents a change in policy or is merely a technical adjustment to changing market conditions.

3. There is some support for eliminating the discount mechanism entirely. This would leave open market operations as the primary tool of monetary

policy. Member banks would then have to make their reserve adjustments through carrying larger idle cash balances, the Federal funds market, other forms of interbank borrowing, the securities market, or changing their loan policy. Otherwise, they would be subject to penalties. Since banks would not be permitted to borrow, there would be no changes in member bank borrowing which might frustrate the economic stabilization policies of the System. The plan, however, would eliminate the "safety-valve" feature of discounting during periods when the Federal Reserve is attempting to curb credit expansion through open market sales. During such periods reserve adjustments might become extremely costly and subject individual banks to severe penalties.

A modified version of this approach would be to maintain a relatively high discount rate of about 2 or 3 percentage points above the current Treasury bill rate. This would usually discourage borrowing. In an emergency there would still be a safety valve with only a modest penalty.



## *Advance Refunding Offer by the Treasury*

**T**HE UNITED STATES TREASURY announced on September 9 an advance refunding of bonds sold during World War II which mature between 1967 and 1969.<sup>1</sup> Holders of these bonds are offered the opportunity of exchanging the 2½ per cent bonds for new 3½ per cent bonds maturing in twenty years, thirty years, and thirty-eight years.

Advance refunding is a method of marketing United States Government securities whereby the holder of an outstanding bond is offered the option to exchange for a new, longer bond with a higher coupon interest rate, some years in advance of the maturity date on the old bond. Advance refunding is an important technique in the marketing of U. S. Government securities involving the following advantages:

1. The investor gains an immediate increase in interest return, in consideration of his acceptance of

a longer-term security; avoids any immediate book loss for tax purposes and, if nontaxable, in most instances is not required to take a book loss; acquires a security whose market yield is at least equal to, and in most cases slightly higher than, that on outstanding issues of comparable maturity, and earns a rate of return over the life of the new security only equalled, if he does not exchange, by reinvesting at maturity of the old security at higher than present market yields.

2. The U. S. Treasury achieves substantial improvement in the present unbalanced maturity structure of the public debt; reduces its dependence on inflationary bank borrowing; retains its customers for long-term securities; and holds down its long-run cost of managing the public debt.

<sup>1</sup> A description of the exchange offering can be obtained by writing to the Federal Reserve Bank of St. Louis.

# *Trends in Government Expenditures*

**F**ROM 1929 THROUGH 1959, annual spending by all governmental units in the United States rose from \$10 billion to \$132 billion (Chart 1). This upsurge has aroused public interest in the purposes for which such outlays are made. Some people suggest that government spending should be timed to promote economic stability, pointing out that since such outlays have become a larger component of national output, the economy has become more vulnerable to expenditure fluctuations than before. Others argue that the amount of government spending should be largely based on the need for goods and services and, therefore, its effect on economic stability is a secondary consideration. Increased government spending has also intensified the perennial question of the role of government in a private economy. There are those who feel that government has been spending money which could better be spent by the private sector, while there are others who believe that government should perform even more services. Regardless of which position is taken concerning the rise in government spending, however, its relationship to the increase in activity in the rest of the economy should be recognized. To place this growth in better perspective is the purpose of this article.

## *Total Government Spending in Perspective*

The increase in Federal, State, and local government spending from \$10 billion to \$132 billion between 1929 and 1959 was only a part of a tremendous expansion in the demand for goods and services that occurred in all sectors of the economy during that period. Government expenditures, however, increased their relative share of gross national product from 10 per cent to 27 per cent (Chart 2). Since spending by various governmental units for various purposes changed at widely different rates, the 17 percentage-point relative increase in government outlays becomes more meaningful if broken down into the purposes for which the funds were applied by Federal and State and local units.

## *Federal Government Expenditures*

From slightly under \$3 billion or one-fourth of total government expenditures in 1929, Federal outlays grew to about \$91 billion or two-thirds of all govern-

ment spending by 1959 (Chart 1). The rise in Federal Government spending represented an expansion of from 2.5 per cent to 19 per cent of gross national product (Chart 2). For purposes of analysis, government disbursements have been broken down between purchases of goods and services and other spending which includes interest payments, transfer payments, grants-in-aid and subsidies.

## **Purchases**

Five-sixths of Federal purchases of goods and services in 1959 pertained to national defense (Chart 3). Amounting to about \$46 billion, these purchases included outlays for the military functions of the Department of Defense, the development and control of atomic energy for peaceful uses as well as for military purposes, stockpiling and expansion of defense production, and military assistance to foreign countries. From less than 2 per cent of GNP from 1929 to World War II, national defense purchases grew to more than 40 per cent during the war. After diminishing to 5 per cent following the war, they expanded again during the Korean conflict, and then leveled off in 1955 at about 10 per cent of GNP. This rise in national defense expenditures over the past 30 years accounted for almost half of the relative increase in spending by all governmental units.

A relatively minor part of Federal purchases, about \$8 billion in 1959, was related to government administration, conservation and development of natural resources, and commerce and housing. These purchases fluctuated both in dollar terms and as a percentage of GNP during the thirty-year period. In 1959 they equaled 1.7 per cent of GNP, compared with a low of 0.5 per cent in 1945, a peak of over 4 per cent in 1939 and about 1 per cent in 1929.

## **Other Spending**

Federal Government spending for purposes other than purchases of goods and services increased from about \$1 billion in 1929 to over \$37 billion in 1959. Interest payments increased, reflecting the expansion of debt during World War II. They were also influenced by a decline in interest rates in the 1930's and a rise since the end of the war. Other types of spending also rose as demands by citizens for more

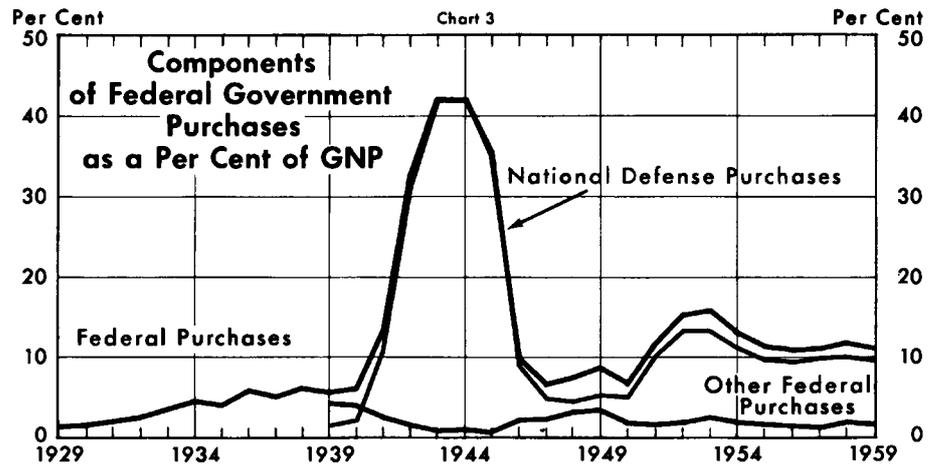
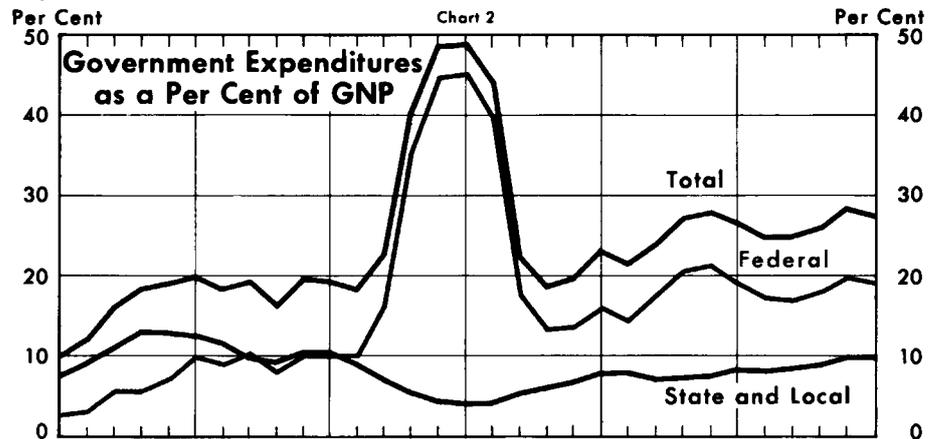
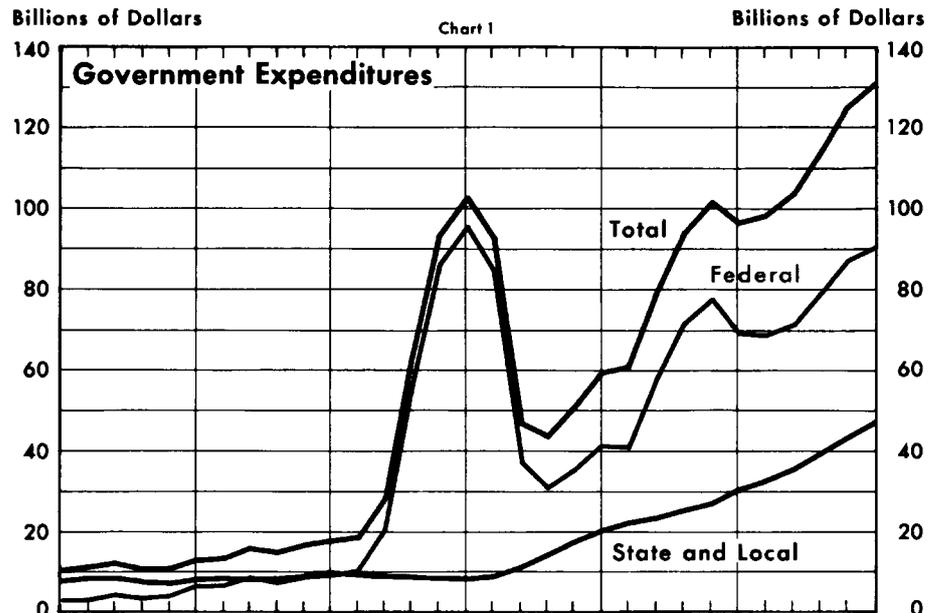
government services grew. Transfer payments increased as a result of the expansion in old age and retirement benefits in recent years. After increasing only slightly for many years, grants-in-aid to State and local governments grew rapidly after 1956, largely because the Federal Government quadrupled its aid for highway building. Subsidies fluctuated, but during the 1950's their direction was upward as the Government spent more to stabilize farm prices and farm income.

The rise in Government outlays, other than those for goods and services, represented an expansion of from 1 per cent to 7 per cent of GNP and accounted for slightly less than half the rise in spending relative to GNP by all governmental units over the past three decades. The relative increase in interest payments, transfer payments, grants-in-aid, and subsidies occurred in two almost equal steps. The first period of relative expansion was the decade of the thirties. Government transfer payments and grants-in-aid to states both rose. The second period occurred during 1944, 1945, and 1946, when interest paid by the Government began to rise primarily because of the increase in Government debt during the war. Since 1946, while one or more of these four types of expenditures may have been more important than the others, as a group they fluctuated around 7 per cent of GNP.

### State and Local Government Expenditures

While State and local government outlays increased from about \$8 billion in 1929 to \$47 billion in 1959, they declined in relative importance from about three-fourths to about one-third of total Government spending, reflecting the climb

in Federal outlays (Chart 1). The increase in State and local spending from 1929 through 1959 was slightly greater than the rise in GNP. These expenditures totaled about 8 per cent of GNP in 1929, declined in relative importance during World War II, and since the war rose to about 10 per cent in 1959 (Chart 2).



## Purchases

State and local government purchases of goods and services, which accounted for the bulk of spending by these governmental units amounted to \$44 billion or 9.2 per cent of GNP in 1959. They included spending for education, highways, health services, police and fire protection, sanitation, housing and community re-development, local recreation, and general government. Throughout the 1930's and early 1940's, annual State and local government purchases amounted to about \$7 billion. They were relatively more important as the economy contracted during the depression and, conversely, declined in relative prominence as the defense effort grew during World War II. During the latter period, military requirements took precedence over civilian requirements, and a backlog of demand for services provided by State and local governments developed. These demands were intensified by a growing population and since 1945 by the acceleration in the trend toward urbanization and "suburbanization." The demand for increased local provision for education and roads has been particularly pressing.

## Other Spending

Transfer payments by State and local governmental units, primarily relief payments and unemployment benefits, rose from \$0.2 billion in 1929 to over \$3.3 billion in 1959 as State and local governments assumed greater social responsibilities. Net interest payments, which amounted to \$542 million in 1929, rose to \$687 million in 1959 after a decline to \$253 million in 1947. They declined in relative importance between 1929 and 1959, however. From 0.5 per cent of GNP in 1929, net interest payments diminished by 1947 to about 0.1 per cent, where they remained through 1959. Much of the fluctuation in interest payments resulted from changes in interest rates; however, over the period under review there was a substantial rise in the size of the debt itself. Transfer payments and interest payments by State and local governments fluctuated around 1.0 per cent of GNP throughout the past three decades with the exception of several depression years when they rose to about 2.5 per cent.

## Conclusion

The dollar spending of all governmental units rose sharply between 1929 and 1959. Placing government growth in perspective with expansion in the rest of the economy, however, we see that the increase in government outlays has not been nearly so great on a relative as on an absolute basis. Consideration of only the dollar amount of growth can be highly misleading.

Total governmental spending grew from 10 per cent to 27 per cent of the gross national product in the past 30 years, but the growth was neither continuous nor general. About half of the expansion occurred in national defense spending by the Federal Government. Defense purchases, after climbing from 2 per cent of GNP to 40 per cent during World War II, returned to 5 per cent following the war, rose to about 13 per cent during the Korean conflict, and subsequently leveled off at about 10 per cent under the pressure of continuing international tension.

Spending by all governmental units for purposes other than military rose from 8 per cent of GNP in 1929 to 17 per cent in 1959. Outlays by the Federal Government for interest, transfer payments, grants-in-aid, and subsidies, like defense purchases, increased in two steps. They rose from about 1 per cent of GNP to about 4 per cent during the depression, as the Government increased its transfer payments and grants-in-aid, and from about 4 per cent to over 7 per cent during 1944, 1945, and 1946 as interest and transfer payments climbed. From 1947 to 1959, these Federal expenditures grew at about the same rate as expenditures in the economy as a whole.

State and local governments in 1959 were spending at a slightly greater rate than they did during 1929. They spent about 8 per cent of GNP during 1929 and about 11 per cent during the depression years but the rate dropped to a 4 per cent level during World War II. Since then, however, State and local government outlays rose to about 10 per cent of GNP as various governmental units tried to satisfy the desires of their citizens for more services. This pattern contrasted sharply with the growth in Federal spending which took place in several steps until a level was reached that has been maintained for several years.

