

# AMERICAN INSTITUTE for ECONOMIC RESEARCH

GREAT BARRINGTON

MASSACHUSETTS

WEEKLY  
BULLETIN

April 3

1950

## RESEARCH REPORTS

### COMING EFFECTS OF CURRENT EVENTS

#### *Monetary, Credit, and Fiscal Policies*

In an earlier article on this subject,<sup>1</sup> we discussed five of the specific recommendations made by a subcommittee of the Joint Committee on the Economic Report. The paragraphs that follow present a continuation of the discussion with emphasis on the function and adequacy of bank reserves and the monetary use of gold.

#### *Reserve Requirements*

The subcommittee recommended that all banks accepting demand deposits be subject to the same set of reserve requirements and that variations in the requirements be based on different types of deposits. Apparently, this recommendation was influenced largely by the views of the Federal Reserve Board; and it is interesting to note that neither that agency, others consulted, nor the subcommittee members considered whether statutory reserve requirements as such were incompatible with sound commercial banking.

Inexplicable as it may seem to the historians of a future century, some of the fundamental principles of commercial banking apparently are being forgotten by our civilization. The combined art and science of central banking, which reached an advanced stage of development in England during the hundred years preceding World War I, may soon be a "lost art" if indeed it is not that already. Brief consideration of certain aspects of the problem will clarify our reasons for the foregoing assertions.

The primary function of commercial banking is to facilitate the production and exchange of goods. This is done, for the most part, by providing credit purchasing media that represent goods produced or value added to goods produced en route to markets. As our readers of course know, the purchasing media, for the most part, are checking accounts created by the banks largely as a result of the lending process.

Reserves are needed by a commercial banking system primarily as a means of insuring the continued ability of the banks to perform their primary function under all foreseeable circumstances. In other words, the primary function of bank reserves is to be available for use in emergencies, just as the function of water reservoirs (or reserves) is to make water available in emergencies when there would otherwise be no water.

Unfortunately, one distinguishing peculiarity of legal reserve requirements is that they virtually insure that the purchasing media needed to finance production and trade will *not* be available in emergencies, because reserves legally required obviously cannot be paid out or loaned. In other words, fixed legal reserve requirements, even statutory minima and maxima no matter how calculated, may prevent the commercial banking system from performing its primary task; and this inability to perform is most probable at those times when such performance is most urgently needed.

That fixed legal reserve requirements are incompatible with sound commercial banking was recognized for several decades, tacitly at least, by the commercial banking system of England, which had no statutory reserve requirements. During that period commercial banking in England was more successful in performing its primary function than bankers elsewhere in the world have been to date.

The idea of fixed legal reserve requirements gained wide popularity in the United States at an early period. The failure of American bankers to learn the art and science of commercial banking from their English contemporaries may have been partly responsible; and the successive waves of bank failures that have engulfed the American banking system on several occasions certainly were sufficient excuse, even if not good reason, for the adoption of such desperate measures as fixed legal reserve requirements.

In any event, the evolution or possibly the retrogression of banking in this country has been reflected in the literature on the subject. Today all attention seems to be centered on the formula to be used in calculating required reserves; whether a legally specified amount of reserves should be required at all is not even discussed.

Fixed legal reserves do not merely restrain activity, they virtually force the money-credit mechanism to cease functioning when it is most needed. Required reserves constitute a harsh mechanism for stopping the money-credit machine. To some extent such reserve requirements function as a brake and exert a restraining force as the legal limits are approached; but, *once the limits are reached*, the gradual braking effect is replaced by sudden stoppage as though a monkey wrench had been dropped into the gears of the money-credit machine.

No one should suppose that fixed reserve requirements have been adopted without some realization of their harsh operating characteristics. However, in the ab-

<sup>1</sup>Page 47, *Research Reports*, March 20, 1950.

sence of a sufficiently widespread understanding of commercial and central banking, required reserves have been assumed in the literature of the subject to be the principal means of preventing disastrous expansions of credit. One might think that the falsity of this assumption would have been sufficiently demonstrated by the inflationary boom of the 1920's and its aftermath, nearly a decade of serious depression; but the Nation has already repeated the inflationary phase of the process, and its bankers apparently are still laboring under the delusion that the right formula for reserve requirements will either remedy the situation or alleviate the aftermath.

Fixed reserve requirements have an added disadvantage in that they encourage "pawn broking" as contrasted with the commercial banking function of banks. Bankers who have excess legal reserves tend to assume that the excess should be used, and "pawn-brokering" or the investment-type loan on real estate, securities, etc., is the only outlet available when the needs of industry and commerce for commercial loans have been met. Thus fixed reserves indirectly encourage bankers to consider that the soundness of a prospective loan and the desirability of making it depend on the adequacy of the collateral rather than the entire nature of the transaction; and, as one consequence of this development, booms and depressions are greatly accentuated by the processes of inflation and deflation.

#### *Misuse of Gold*

Also encouraged by fixed reserve requirements is a failure to use gold most effectively as a guide to central-banking policy. Ordinarily, gold is the principal reserve of a central bank. The analogy of a water-supply system is especially helpful in understanding the principles involved.

If a marker were placed at a certain elevation in a water-supply reservoir and all outlet valves were shut when the water fell to the marked level, the water supply would be operated as we now operate our money-credit system. If, however, instead of watching a specific mark, the *direction and rate of change* of the water level were watched, outlet valves could be adjusted in such a manner that some water would be flowing in the pipe distribution system at all times. A procedure very much like this was followed by England's central-bank managers for several decades prior to World War I. We suspect it was no accident that England was the leading financial power of the world during that period.

Because the direction and rate of change in the gold reserve is one of the essential guides to central-banking policy, resumption of the complete gold standard would be helpful. If that were done, the subsequent inflow and outflow of gold would serve as one guide in the formulation of central-banking policy. Primarily for that reason, we consider that the subcommittee's recommendation to postpone convertibility of gold was unwise. Other reasons for resuming the gold standard were stressed by various economists whose statements were published by the subcommittee, but these aspects of the subject have been discussed elsewhere in these bulletins.<sup>2</sup>

#### *Other Recommendations*

The subcommittee has recommended "the creation of a National Monetary and Credit Council which would include the Secretary of the Treasury, the Chairman of

the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, and the heads of the other principal Federal agencies that lend and guarantee loans. This Council should be established by legislative action, should be required to make periodic reports to Congress, and should be headed by the Chairman of the Council of Economic Advisers. Its purpose should be purely consultative and advisory and it should not have directive power over its members."

Although this council is intended to be "purely consultative and advisory," we believe that it would be politically dominated. The recommendations of a group consisting largely of members of the party in power at the moment cannot be expected to provide the results of impartial and unbiased analysis.

The subcommittee recommendation that the use of money and credit be based on changes in employment, changes in production, and other evidences of "prosperity" and "depression" ignore the underlying function of monetary policy. Professor Frederick A. Bradford's statement to the subcommittee outlines what we consider a better procedure. "The objectives of credit policy—should be (a) the maintenance of sound credit conditions, and (b) the stabilization of business at a satisfactory level so far as this is possible and compatible with (a) above. I do not favor the stabilization of the general price level as a major objective of credit policy for the reason that a substantial rising or falling price level is the result of maladjustments which have previously developed in the economy. Credit policy should aim at preventing \* \* \* this maladjustment. If successful in this, alarming movements in the general price level will not occur. For similar reasons, I do not view the amount of employment as a main criterion of credit policy \* \* \*. The law should require that demand deposits of the banks should be offset on the assets side of the statement by working-capital or self-liquidating paper and reserves only, investment-type assets being limited to the banks' capital funds and savings deposits."

The consequences of substantial inflation and deflation are extreme prosperity and depression, respectively. Many persons, including those on the subcommittee, who are appalled by the effects of depression would remedy a recession by encouraging inflation. That such action defeats the purpose of the deflation, which is to purge the system of the maladjustments brought about by inflation, is overlooked in the zeal with which the symptoms are attacked. Until those persons conducting our economic affairs learn that deflation can continue only as long as there is inflationary purchasing media in the economy, they probably will continue to "combat" deflation instead of prevent inflation. And as long as we refuse to eliminate the inflationary purchasing media from circulation, our monetary policy probably will be distorted by unwise attempts to remedy the symptoms of economic maladjustments.

#### *Conclusions*

*The recommendations of the Douglas report on monetary, credit, and fiscal policy are primarily an attempt to deal with certain symptoms of the economic maladjustments that have been created largely as a result of inflation. Several of the recommendations are sound, but others are of questionable value.*

*Our primary monetary problem today is to eliminate*

<sup>2</sup>"Return to Gold?" *Research Reports*, November 21, 1949.

the inflation that has greatly distorted economic relationships. The Douglas report is helpful to some extent but fails to grapple with the fundamental difficulties involved.

## SUPPLY

### Industrial Production

Steel-ingot production, scheduled at 96.7 percent of capacity for the week ended April 1, 1950, was 1.1 percent more than that in the preceding week and was slightly more than that in the corresponding week last year.

	1929	1932	1937	1938	1949	1950
Percent of Capacity†	95	22	90	36	100	97p
Weekly Cap. (Million Tons)	1.38	1.52	1.51	1.54	1.84	1.91
Production (Million Tons)	1.31	.33	1.36	.55	1.84	1.85

Automobile and truck production in the week ended March 25, 1950, in the United States and Canada was estimated at 134,978 vehicles, compared with a revised total of 134,453 vehicles for the previous week.

	1929	1932	1937	1938	1949	1950
Vehicles (000 omitted)†	137	37	101	57	121	135p

Electric-power production in the week ended March 25, 1950, decreased to 5,993,062,000 kilowatt-hours from 6,015,327,000 kilowatt-hours in the previous week.

	1929	1932	1937	1938	1949	1950
Billion Kilowatt-Hours†	1.66	1.48	2.15	1.98	5.38	5.99

Lumber production in the week ended March 18, 1950, increased. *The New York Times* seasonally adjusted index was 2 points more than that for the previous week and was 19 points more than that for the corresponding week last year.

	1929	1932	1937	1938	1949	1950
The New York Times Index†	125	40	94	88	88	107

†Latest weekly data; corresponding weeks of earlier years

p=preliminary

## DEMAND

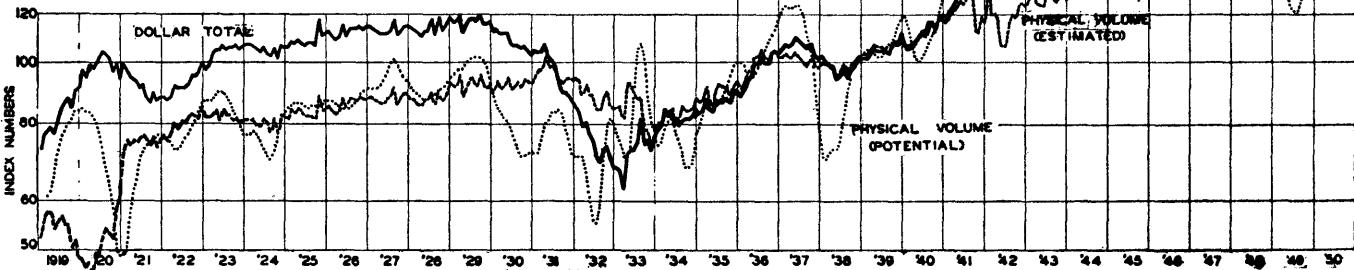
### Department-Store Sales

Department-store sales (seasonally adjusted) during February were unchanged from those during January and were slightly greater than those of February 1949. Preliminary data indicate that a decrease occurred during March.

The decrease in the prices of goods sold in department stores was not large enough to affect the index of the physical volume of department-store sales; consequently, that index also was unchanged during February.

Insufficient data make an estimate of the February potential physical volume of department-store sales difficult. (Our index of the potential sales volume is based on the production of goods usually sold in department stores.) Consequently, our usual clue to the trend of inventories once again is not available. However, judging by department-store inventories at the end of February in the Second Federal Reserve District, inventories increased slightly during the month.

Comparisons of weekly sales during March and April



with those of the corresponding weeks of March and April 1949 may be misleading because Easter will be 1 week earlier this year than it was in 1949. Ordinarily, department-store sales increase markedly in the 4 or 5 weeks before Easter. In order to have a basis for comparison during the weeks before and immediately after Easter, we have analyzed the changes in sales during the corresponding weeks of the past decade. The average increases in sales from the base period (the average of the 6th to the 9th week inclusive preceding Easter) were 6, 14, 21, 28, and 37 percent for the 5th, 4th, 3d, 2d, and 1st weeks preceding Easter. The changes were nearly uniform in all except some of the war years.

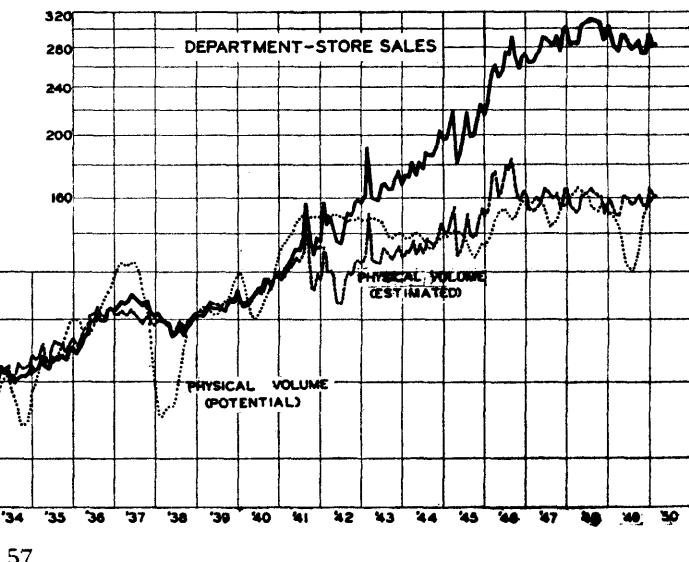
Department-store sales in the week ended March 1 increased nearly 11 percent from the average of the base period, more than the usual gain for the 5th week preceding Easter; and in the week ended March 18 the increase over sales in the 1950 base period was 15 percent although the usual gain has been only 14 percent. Furthermore, sales data for the week ended March 25 indicate that an increase slightly greater than that ordinarily expected for the 3d week before Easter occurred.

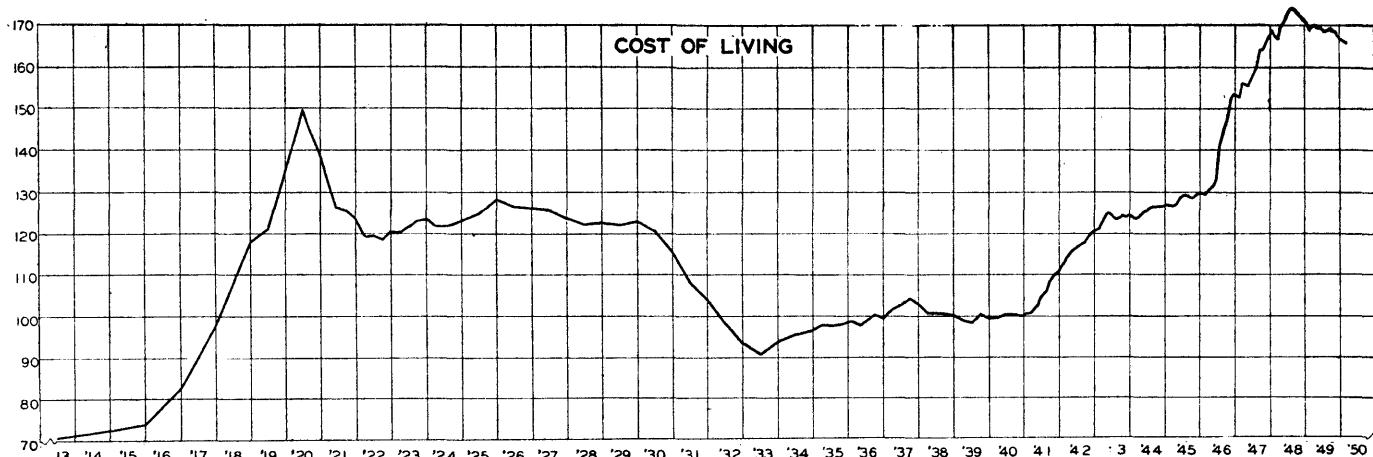
In order to equal the average pre-Easter gains, department-store sales in the 3d, 2d, and 1st weeks preceding Easter this year will have to compare with sales in the corresponding calendar weeks of last year as follows: week ended March 25, equal to those of the week ended March 26, 1949; week ended April 1, not less than 2 percent less than those of the week ended April 2, 1949; week ended April 8, not less than 2 percent less than those of the week ended April 9, 1949. The comparisons of weekly sales with those of the corresponding week a year earlier are reported regularly in *The New York Times*, *The Wall Street Journal*, and many other newspapers as well as in these bulletins. By comparing the reported figures with those indicated above, subscribers will have the earliest possible information on the trend of department-store sales.

*The resumption of coal mining, the recovery of the steel industry, the increased activity of industry in general, and the present substantial amounts of purchasing media in circulation should maintain department-store sales at high levels for several weeks.*

### Latest Weekly Data

Department-store sales for the week ended March 25, 1950, were 5 percent more than sales for the previous





week and were slightly more than sales in the corresponding week last year.

## PRICES

### *Consumers' Prices*

The prices of goods and services bought by moderate-income families in large cities decreased slightly during the month ended February 15, 1950, thereby continuing the uninterrupted decline that began in December. Since last November the Department of Labor's index of consumer prices has decreased 1 percent. The preliminary mid-February figure was nearly 5 percent below the high reached in September 1948 and was at the lowest level reached since November 1947. Slightly lower prices for foods and apparel during the period between January 15 and February 15 more than counterbalanced slight gains reported for fuel and electricity, housefurnishings, and rents.

Food prices decreased in February for the third consecutive month and were 10 percent below the highs reached in July 1948. Lower prices for meats, particularly beef, pork, and chickens, have contributed most to the decreases that have occurred in the food component in recent months. The prices of chickens decreased markedly, 6 percent, in January alone; and pork was approximately 22 percent below the level of prices reached last fall.

Apparel prices have decreased steadily since October 1948, and in February were 8 percent below the high reached in the earlier month. Fuel and light prices, on the other hand, increased for the eighth consecutive month in February. Rents have increased almost without interruption since the end of the war and increased further in February. Housefurnishing prices increased slightly, and the prices of miscellaneous items were virtually unchanged in February.

In view of the recent action of Congress regarding the increase in funds for the Commodity Credit Corporation, the acreage restrictions on certain crops, and the plans for disposal of surplus crops, lower price floors for farm products in the immediate future do not appear probable. In view of the fact that the prices of many of the food staples are near the support level, further substantial decreases in the prices of certain foods, such as pork and chickens, may not occur.

*The further inflation expected together with the continuance of farm parity prices at high levels presumably will prevent marked declines in the cost of living in the next few months. However, the general trend is expected*

*to be either a leveling off or slight downward trend for some time to come.*

## *Commodities at Wholesale*

	1949 (August 1939=100)	1950 Mar. 30	1950 Mar. 23	1950 Mar. 30
Spot-Market Prices (28 basic raw materials)	257	246	247	
Commodity Futures Prices (Dow-Jones Daily Index)	265	277	285	

## BUSINESS

### *Private Contracts for Engineer Construction*

The 3-month moving average of private contract awards for heavy engineering construction increased 9 percent during February to a new all-time high. The February average was 10 percent above that of February 1949, which was a record prior to January of this year. The dollar value of contract awards in February was 4 percent less than the dollar value of awards made in the previous month but was nearly \$100,000,000 more than that for last November, which was the month dropped from the 3-month moving average on the chart for February.

Construction costs increased further in February to another new high. However, the increase was not so large as to affect greatly our estimate of the physical volume of engineering construction, which increased nearly 9 percent during February. The physical volume of engineering construction is still approximately 15 percent less than the all-time peak reached in the middle of 1946.

Data for private engineering construction for the first 3 weeks of March reveal that, if private contract awards for engineering construction in the fourth week equal the average for the preceding 3 weeks, the total for the month may exceed that for February by as much as 15 percent. The total for 3 weeks of March already is nearly as large as the total for December, which will be dropped from the 3-month moving average for March. Therefore, the 3-month average dollar value of private engineering construction for March probably increased further to an all-time high.

*In view of the level of engineering construction already reached, the seasonal increase of such activity may help to maintain record levels during the first half of this year. In fact, a record dollar value of heavy construction for the year would not be surprising.*