

CAN THE FEDERAL RESERVE SYSTEM STABILIZE PROSPERITY?

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The Federal Reserve System was originally established to cope with the seasonal fluctuations in the demand for money by providing centralized reserves available, through rediscounting, to any bank having eligible paper in its portfolio. We are now faced with the more urgent problem of cyclical fluctuations which cause not only monetary stringencies but innumerable other difficulties such as unemployment on a large scale. Economic statesmanship involves the attempt to solve these problems with the minimum political, social, and economic disturbance. The Federal Reserve could as easily provide a technique for contra-cyclical policies to lessen the impact of the downswing of the business cycle as it has furnished the mechanism for meeting the demands of crop-moving time. Self-interest is the only motivation which can be relied on as a business stimulus. What is needed, then, is to discover how the Federal Reserve can aid business to generate the market for its product during depression conditions.

No matter how different one business cycle is from another so far as its cause is concerned, all cycles have the same general result of reducing employment, cutting down buying power, and discouraging initiative. Our economy swings from periods of over-investment to periods of under-investment, depending on whether new investments (not counting refunding) are in excess of current net savings. There is a variety of highly reliable statistical devices which would determine whether our economy is in a period of over-investment or under-investment at any time. At present the latter is the case, as marked by sluggish capital markets, cheap money, low prices, idle factories, and excessive unemployment. The Federal Reserve, through its Research Division, should be in a position to make such determinations very reliably as a guide in the carrying out of the contra-cyclical policies herein proposed.

An individual businessman would be happy to take advantage of the low wages and cheap materials characteristic of a period of under-investment in order to build up a stock of raw materials and semi-finished goods so that he might be in a favorable position "when things pick up." But, playing a lone hand against the world, he does not dare do this, nor can he do so if he wished. He is not sure of the needed credit backing, he does not know the extent to which his competitors might also embark on the same program, thus endangering the position of all, nor has he any assurance that the small amounts of new buying power which his operations make available for the market would come back and purchase his particular product.

What is not possible for an individual businessman, however, is within the power of a whole banking system having central rediscounting. Let the Federal Reserve make available, solely during periods of under-investment, a special classification of credit to be called "preferred credit." Individual enterprisers would apply for this credit at their local bank, submitting a bid which would specify the semi-finished product to be produced, the volume of such production, the contemplated prices of the product, and other relevant data. Such applications, when tabulated by product, by districts, by physical volumes, and by contemplated prices, would then be forwarded to a special agency of the Federal Reserve. It would be the duty of this agency to suggest allocations of the available credit in such a way as to avoid

the dangers of over-production in certain lines, to encourage production along those lines indicated by actual consumer purchases, and so as to be sure that those enterprisers who demand the highest net (contemplated) prices for their product would be accommodated only after their competitors had been provided with the credit they needed. The Federal Reserve would not lend any money directly, but it would stand behind the loans which had met its approval with the assurance to the local banker that he could classify this loan a "preferred credit" for purposes of bank inspection and for rediscount if desired. Since this credit would be spread over the whole country there would be every reason to expect that the increased buying power thus made available would come back rather promptly into the market in the purchase of all sorts of consumers' goods. The first marked effect of this new policy would be a shrinkage of consumers' goods inventories, which would stimulate the production of such goods, and this would encourage the installation of new capital equipment.

A relatively high percentage of this new buying power would flow into the pockets of wage earners, since this new credit could not be used to finance any distribution of profits to the enterprisers concerned, nor could it be used for price-speculation. Owners would, of course, earn their profits on such business as soon as these semi-finished goods flowed into the production of finished goods. The stored surpluses of semi-finished goods held in these "contract inventories" would automatically prevent a run-away price boom, and this would permit the earning of reasonable profits on the new business without "diluting" the new buying power thus created. The evil day of reckoning of the next depression, caused by the collapse of an inflated price structure, would thus be postponed, perhaps indefinitely.

Thus during any period of under-investment the deficiencies of buying power engendered by this very shortage of investment would be compensated by increased allocations of preferred credit for the production of the semi-finished goods which will most probably be needed during the ensuing period of prosperity. This increased purchasing power would permit the operation of industry on a stabilized program of maximum production, and would maintain buying power on a level sufficient to buy back all actual output of finished goods. When, as a result of this stabilization, returning confidence caused a pick-up in investing, the increased buying power flowing from this source would be compensated for by cutting off the flow of preferred credit.

This new credit would thus be "thermostatically controlled" so that it would be turned on when there was need for it, and off when the need had passed. It would be restricted to semi-finished goods which can be used in a wide variety of finished goods, in order to lessen any danger of ultimate unsalability. This restriction to semi-finished goods would have the further advantage that the creation of preferred credit would automatically generate a market for finished goods while not enlarging the supply of such goods, thus tending to strengthen the market for such goods. Thus business cycles, instead of being fluctuations in the total physical volume of production, would be merely shifts of a certain rather moderate percentage of labor and capital from the production of semi-finished goods (during periods of under-investment) to the production of new capital goods (during periods of prosperity) and back again. One of the chief advantages of this program is that it would be almost automatic in operation, involving the minimum of administrative interference with normal business processes. Preferred credit would be available only through regular financial channels, and would be subject to the same tests as to soundness and "acceptability for rediscount" that any other form of bank credit must meet, with certain additional tests imposed by the agency charged with its allocation. It would not be necessary to create a great bureaucracy for this purpose, since most of the work of sifting these credit applications would be done by

the individual banks which endorsed the notes before submitting them to the Federal Reserve for approval.

This program would not be directly applicable to agriculture, fisheries, or other industries having a large "weather hazard." Nor would it apply to the professions, service trades and small artisans. But it would greatly increase the market for such goods and services, and would tend to draw "marginal men" back from such fields into industries affected by this program. This would be an economic boon for these classes. It is not contended that this program would completely "solve" all our economic problems, nor is this program offered as a panacea. But it would seem logical that this auxiliary type of credit could not fail to render a valuable service during periods of under investment. Being available only through existing bank channels it could not be forced on the business community in amounts greater than the community is willing and able to employ. Such a proposal involves the minimum possible change in our existing business and banking techniques. Business would still remain entirely in private hands, functioning under a system of individualistic competition which would maintain efficiency and insure economic progress and stability. And the primary advantage possessed by this program would be its tendency to lessen unemployment, returning workers to normal gainful employment.

This brief statement of these proposals is intended only to indicate the general lines along which such a program must evolve. The Board of Governors of the Federal Reserve System has taken this proposal under advisement, and certain items of the present statement have been the result of suggestions kindly offered by the research technicians on the staff of the Board. Any person wishing to contribute criticism or suggestions for the further development of these proposals is invited to communicate with the author.