

Mr. Chairman:

Almost a year ago, in the earlier part of 1960, the Federal Reserve System began to lean against the incipient down-wind of what has come increasingly to be classified as the fourth cyclical decline of the postwar era.

Already, as the winter faded, and with it the inflationary psychology that had characterized the economic situation carrying over from 1959, bank reserve positions--which govern the ability of the banking system to expand loans--had been made less dependent on borrowed funds.

Then, with the spring in progress, the Federal Reserve moved further: first, to promote still greater ease in bank reserve positions; and next, beginning in May, to provide additional reserves to induce a moderate expansion in bank credit *and the money supply*.

In this period in particular, new supplies of reserve funds were injected into the economy by means of open market operations. The first effect was to enable member banks to reduce appreciably their reliance on borrowed reserves. After this was accomplished the added reserves went to support the potential for bank credit expansion. In these open market operations, from late March through July, the Federal Reserve paid out about \$1.3 billion, net, for the Government securities it was buying on an increasing scale. After cushioning the reserve impact of a \$500 million increase of currency in circulation and gold outflow, this sum made possible a \$300 million reduction in member bank borrowing and a \$500 million increase in member bank reserves.

But other means available for the execution of System policy were used as well, particularly after mid-1960.

In early June, and again in August, discount rates were reduced, by 1/2 percentage point each time. These reductions lowered the cost of member bank borrowings from the Federal Reserve Banks to 3 per cent from the 4 per cent level that had prevailed before.

In August also, and again in November, by actions taken in implementation of a 1959 Act of Congress, nearly \$2 billion previously tied up in vault cash of member banks was released to assure ample coverage of heavy borrowing needs for the fall and pre-Christmas seasons. An additional \$700 million was provided by further net purchases of U. S. Government securities.

After midyear, ^{the task of} monetary policy ^{was complicated by} had to cope with an outflow of gold exceeding \$1.5 billion. Thus, a substantial part of the reserve funds provided by the System in this part of the year went to offset the effect of this outflow on member bank reserves.

Taking the year 1960 as a whole, the change in bank reserve positions was dramatic. From net borrowings from the Federal Reserve of \$425 million in December 1959, member banks as a whole moved by December 1960 to a surplus reserve of \$650 million. The total turn-around exceeded a billion dollars.

Nevertheless, the money supply showed a stubborn downtrend until mid-1960. In the spring, bank credit seemed to respond less promptly to easier reserve conditions than in comparable periods in the

past. After May, however, the seasonally adjusted money supply did begin to reflect our actions. In the second half of the year, the money supply rose at an annual rate of about 1.5 per cent. By year end, it had risen to \$140.5 billion, just below the end-of-1959 peak. The money supply has expanded further in January and February of this year. Indeed, the annual rate of increase calculated from the performance of these two months was in the neighborhood of 4 per cent and the total money supply is now above year-ago levels.

The savings and time deposits of banks continued to grow in 1960 and after midyear the pace of growth was unusually rapid. This increase in time deposits permitted an increase of total bank loans and investments for the year as a whole by \$8.4 billion. That was twice as much as the year before.

Total credit in the economy ^{in 1960} expanded by some \$37 billion. That figure was about two-fifths less than the record expansion of \$61.5 billion in 1959, on which I reported to you a year ago, and more nearly in line with total credit extensions of other recent years. The smaller growth in 1960 was attributable to reduced pressure of borrowing demand, especially on the part of the Federal Government. The most significant thing about the Federal Reserve's operations in 1960 is not that they were extraordinary but, instead, that they were typical of Federal Reserve operations under the flexible monetary policy that has been in effect now for a full decade.

That policy, as I have capsuled it before in the shortest and simplest description I have been able to devise, is one of leaning against the winds of inflation and deflation alike--and with equal vigor.

It is, in my opinion, the policy that the Federal Reserve must continue to follow if it is to contribute to the provision of conditions conducive to a productive, actively employed, growing economy with relatively stable prices.

Yet, while the necessity for adhering to that policy remains as great as ever, the difficulty of executing it has become vastly greater. This is so because of economic and financial cross-winds that have been developing for years and, since mid-1960, have been gaining in force.

The problem, it now appears, and it is by no means a problem for monetary policy alone, is to lean against cross-winds--simultaneously. I do not know how effectively this can be done. I do know, however, that it will not be easy--just as the problems of monetary policy and of other financial policy have never been easy.

To put in perspective the problems that the Federal Reserve faces today--and how it is adapting to this problem--let me briefly review monetary policy over the past 20 years.

Immediately upon the United States' entry into World War II in December 1941, the Board of Governors announced that the Federal Reserve was prepared--

1. "To use its powers to assure that an ample supply of funds is available at all times for the war effort, and
2. "To exert its influence toward maintaining conditions in the United States Government security market that are satisfactory from the standpoint of the Government's requirements."

Making good on its words, the Federal Reserve saw to it that the banking system was supplied with ample lendable reserves to provide the Government with all the war-financing funds that it could not raise through taxation and through borrowing people's savings.

It did so by buying outstanding Government securities on a huge scale. The Federal Reserve's payments for these securities wound up in bank reserves. In turn, the banking system used these additional reserves to purchase new securities that the Treasury was issuing to obtain further funds to finance the war effort.

To keep the process going, the Federal Reserve in effect maintained a standing offer to buy Government securities in unlimited amount at relatively fixed prices, set high enough to assure that their interest rates or yields would be pegged at pre-determined low levels. When no one else would accept those yields and pay those prices, the Federal Reserve did so. And in so doing, it helped to finance the war.

The process was successful for its emergency purpose. But the procedure of pegging Government securities at high prices and low yields entailed a price of its own that the economy--the people and the Government alike--would later have to pay. The results were two-fold:

1. During wartime, money was created rapidly and continually, in effect setting a time bomb for an ultimate inflationary explosion--even though the immediate inflationary consequences were held more or less in check by a system of direct controls over prices, wages, materials, manpower, and consumer goods.

2. The market for Government securities became artificial. The price risks normally borne by participants in that market were eliminated: bonds not payable for 20 years or more became the equivalent of interest-bearing cash since they could be turned into cash immediately at par value or better--at the option of the owners, at any time.

The pegging of yields and prices of Government securities was continued for some time after the war to provide a gradual transition to a market freely responsive to the changing demand for and supply of securities. A gradual transition was especially important because capital values generally had become moored to the artificial yields and prices in the pegged market for Government securities.

By 1950, however, the need to end the dependence of the Treasury and the Government securities market upon money creation by the Federal Reserve, and to halt the inevitable inflationary consequences, had become clear to many observers. The outbreak of hostilities in Korea and the inflationary crisis that accompanied ^{it} brought the matter to a head.

Understanding of the problem was enhanced by an exhaustive investigation conducted by a Special Subcommittee of the Joint Congressional Committee on the Economic Report, under the chairmanship of Senator Paul Douglas. In its report in January 1950, the Congressional Subcommittee said means must be found for discontinuing the pegging of the Government securities market--if financial stability and effective control over the creation of new money were to become possible in the decade of the 1950's.

After considerable negotiation, the Treasury and the Federal Reserve System reached an Accord, jointly announced by them on March 4, 1951, that served to recognize and reaffirm that:

1. To serve the public welfare, Federal Reserve policy must be directed toward maintaining monetary conditions appropriate for the economy as a whole, rather than toward special treatment for the Treasury and the Government as if their interests could differ properly from those of the people as a whole.

2. Likewise to serve the public welfare, the Treasury's borrowing operations in management of the Government's debt must be reasonably calculated to induce loans to the Government in an economic system where no one can be compelled to lend his money at interest rates that he would be unwilling to accept voluntarily.

Thus, the Accord re-established the complementary operation of monetary and debt management policies: by the Federal Reserve, to regulate the availability, supply, and cost of money with a view to its economic consequences; by the Treasury, to finance the Government's needs in the traditional context of a competitive market.

To provide for the gradual withdrawal of the pegs that had fixed market prices and yields, several procedures were instituted immediately and carried out over the next weeks and months.

That's much easier to say now than it was to do then. For this was the danger:

1. Hanging over the market like a storm cloud were two issues of the longest term, 2-1/2 per cent bonds, outstanding in the total amount of \$19.7 billion. Their prices had been propped around 100-3/4 throughout January and February 1951, by price-supporting purchases.

2. Although these bonds were not due for redemption until 1967-72, they were instantly saleable in markets. In fact, many of their holders were exercising their right to sell--and selling in large amounts--so as to reinvest the proceeds in private securities yielding a higher return.

3. Even a lowering of the price props, much less a complete withdrawal, might very easily cause holders of these instantly marketable

the Federal Reserve ceased buying almost altogether: purchases during the entire last half of 1951 totaled only \$20 million. And prices, which had been supported around 100-3/4 at the start of the year, fluctuated around 97 during the last half of the year when the bond market was on its own.

As the years 1951 and 1952 progressed, however, market developments demonstrated a disturbing skepticism among investors that the Federal Reserve was in fact abstaining (or would continue to abstain) from attempting to maintain certain predetermined interest rates, regardless of the over-all state of the demand for and the supply of savings. This skepticism was fed by market observation that the System engaged in purchases of securities involved in Treasury financings around the periods of such financings.

After very careful study of the functioning of the Government securities market and of the relation of Federal Reserve monetary operations to the market, the System decided that it would limit its open market transactions to short-term securities, usually those of the very shortest term: Treasury bills. It also decided to refrain from operations in securities involved in Treasury financings. In taking these steps, the Federal Reserve objective was to convince the market that it was not undertaking to peg interest rates--and most certainly not those on intermediate- and long-term securities.

Accordingly, to minimize market uncertainty as to possible Federal Reserve operations affecting market rates, and thereby to aid the effective competitive functioning of the market, the System announced in April 1953 that until further notice, unless disorderly conditions arose in the market, it would operate only in the short-term area, where its operations would have the least market impact.

securities to unload them on the market so heavily as to cause a collapse in the market that might, in turn, provoke a sharp economic setback.

Since the primary necessity was to safeguard the market and the economy against that danger, these were the first steps taken under the Accord:

Holders of the overhanging, fully marketable 2-1/2 per cent bonds of 1967-72 were offered an opportunity to exchange them, in early April 1951, for 2-3/4 per cent bonds of 1975-80 that could not be sold at all although they could, at the holder's option, be converted into 1-1/2 per cent notes carrying sale privileges.

While the exchange was being effected, support buying was continued by the Federal Reserve and the Treasury, but at declining prices: from January through April, net purchases by the Federal Reserve totaled approximately \$1.4 billion. When the exchange was completed, the offer of nonmarketable bonds had been accepted on a scale sufficient to remove from the market \$13.6 billion of the overhanging marketable bonds, including \$5.6 billion that had been held by the Federal Reserve and the Treasury.

This exchange paved the way for discontinuance of Federal Reserve purchases of Government bonds in support of their prices.

In May and June, net purchases by the Federal Reserve of long-term bonds dropped off to \$250 million, but that was enough to assure against development of disorderly conditions in the market. After that,

I think I should point out here, in fairness to my colleagues on the Federal Open Market Committee, that in this decision to limit our open market operations to the short end of the market, we were not unanimous--neither then, nor since then.

Indeed, the divergence of views in the System on this question has been more marked and more continuous than on any other that I can recall in my ten years in the Federal Reserve. That, I think, is readily understandable because the question relates to the techniques of open market operations--a highly technical and involved subject--rather than to general credit policy itself.

In my opinion, it is and always will be easier to achieve full agreement on what to do than on how to do it. To me, that explains why the uninterrupted character of the divergence in the System over operating techniques contrasts sharply with the rather high degree of agreement we have had, most of the time, over questions of general credit policy--whether and when to ease or restrain, and how much. Also, why it contrasts completely with the undeviating firmness of our opposition, at all times, to returning to a pegged market.

These matters, however, are too well known to members of this Committee for me to labor them further at this point: the records of your past hearings, as well as our Annual Reports, contain the views on that score of several members of the Open Market Committee, including the former and the present vice chairmen of our Committee, Messrs. Allan Sproul and Alfred Hayes of the Federal Reserve Bank of New York, as well as myself as chairman.

In any event, following the 1953 decision I have described--the decision to confine our open market transactions to the short-term sector of the market--the emphasis in Federal Reserve operations continued to be placed upon providing bank reserves to meet the economy's needs rather than to set particular rates of interest. Inevitably, however, interest rate movements, since they reflected basic demand and supply conditions, continued to be one of many factors considered by the Federal Reserve in making judgments about the need for changes in the reserve base. Conversely, Federal Reserve operations in the market continued, inevitably, to be an important influence affecting the general level of market interest rates..

Despite confinement of its operations ordinarily to the short-term area, the Federal Reserve stood prepared to buy securities other than Treasury bills should unusual developments create disorderly conditions in the Government securities market and thus in credit markets as a whole. When disorderly conditions seriously threatened as in late November of 1955 or actually developed as in the summer of 1958, the Federal Reserve bought longer term securities to maintain or re-establish orderly trading. Apart from these exceptional and infrequent circumstances, however, the Federal Reserve maintained its reliance upon operations in Treasury bills without interruption until 1960. With the introduction of the 6-month Treasury bill in 1958 and the 12-month Treasury bill in 1959, the System extended the maturity range of its operations within the short-term area.-

Toward the close of 1959 there were increasing indications, signaled by rapid rises in market interest rates accompanying a mounting intensity of borrowing demands, that conditions bordering on the disorderly

might be encountered increasingly in the future and that there might be more occasions than in the past for corrective operations by the Federal Reserve in maturities beyond the range of Treasury bills.

After the middle of 1960, another consideration pointing to a possible need for Federal Reserve operations in longer term securities arose from the convergence of two important developments.

1. On the domestic front, a decline in key sectors of business activity, accompanied by gradual rise in unemployment, suggested that the economy might be moving downward on a broad pattern of recession.

2. In the area of international financial accounts, a big deficit in the U. S. balance of payments was made larger by a substantial outflow of short-term funds from the United States to foreign money centers, partly in response to higher interest rates abroad.

As I stated earlier, the Federal Reserve had been making bank reserves available to ease the credit situation since the winter of 1960. Thus, it had been a contributing influence in the decline in market interest rates to mid-1960. In the light of the domestic business and employment situation and the balance of international payments deficit, this decline presented us with a dilemma in the latter part of 1960.

If the Federal Reserve continued to supply reserves by buying only Treasury bills, the direct impact of its purchases might drive the rate on those securities so low as to encourage a further outflow of funds to foreign markets and thus aggravate the already serious balance of payments deficit.

If, on the other hand, the Federal Reserve refrained from further action to supply funds for bank reserves because of the balance of payments

situation, it would be unable to make its maximum contribution toward counteracting decline in domestic economic activity through the stimulative influence of credit ease.

Thus, in an effort to expand reserves and yet to minimize the repercussions on the balance of payments, the Federal Reserve began, in late October 1960, to provide some of the additional reserves needed by buying certificates, notes, and bonds maturing within 15 months. Since that time, the System has bought and sold such securities, in addition to bills, on a number of occasions, duly reporting these portfolio changes in a public statement issued every Thursday.

Now here let me note something about the decline in interest rates that took place in 1960. During the first eight months, market rates on Treasury bills and intermediate-term issues fell much more sharply than on bonds; as is usual in a period of declining rates.

After late summer, however, the differential between short- and long-term rates ceased to widen, and the average level of rates itself remained relatively unchanged. The increased net outflow of domestic and foreign capital from the United States in the second half of the year, in response partly to the attraction of higher interest rates and potential capital gains abroad, was itself a factor in keeping interest rates in the United States from declining, because it reduced the supply of funds available here.

It was in the latter part of 1960, as I have noted, that Federal Reserve operations were directed more and more toward reducing the direct impact on Treasury bill yields of Federal Reserve purchases. Thus, when

the System was providing for the large seasonal expansion in credit needs that occurs in the fall and pre-Christmas seasons, it did not rely solely on further open market purchases but took actions that made vault cash holdings of banks fully available for meeting reserve requirements. And on the occasions when the System did engage in open market operations, it often conducted these operations in short-term Government securities other than Treasury bills.

With the domestic economy and the balance of payments continuing to pose conflicting problems, open market transactions in securities other than Treasury bills are continuing. Beginning on February 20, as we stated in an announcement issued on that date, a copy of which is attached to this statement, the Federal Reserve has engaged in purchases of securities having maturities beyond the short-term area, putting to practical test some matters on which it has been possible in recent years only to theorize.

There is still a question as to the possibility of bringing about a meaningful decline in longer term rates through purchases of longer term securities without, at the same time, causing a shift in market demand toward short-term securities that would also press down levels of short-term rates.

On the other hand, it seems to me, few could question the desirability of the result, if it can be attained, as a means of keeping financial incentives attuned to the current needs of our domestic economy and our international financial position.

We will want to observe closely, of course, the effect of this change in operating techniques on the market and its capacity to fulfill

its role in transferring a large volume of securities among our various financial institutions to facilitate their responses to shifts in the supply of savings and the demands of borrowers.

In our country, the Government cannot force anyone to lend his money at rates he is unwilling to accept--any more than it can force him to spend his money at prices he is unwilling to pay. In the securities market, investors always have the alternative of investing their funds in short-term securities if they feel that yields in the longer-term area are unfavorable. Therefore, in the outcome of this test much will depend on the reactions of investors.

As I have said many times in the past, before this Committee and others, I am in favor of interest rates being as low as possible without stimulating inflation, because low rates can help to foster capital expenditures that, in turn, promote economic growth.

Yet, as I assume we can all agree, interest rates cannot go to and long remain below the point at which they will attract a sufficient volume of voluntary saving to finance current investment at a relatively stable price level. At least we can agree, I think, that interest rates cannot be driven and long held below that point without resort to outright creation of money on such a scale as to invite inflation, serious social inequity, severe economic setback, and, under present conditions, an outflow of funds to other countries and consequent drains on this country's gold reserves.

I do not believe anyone expects the Federal Reserve to engage in operations that will promote a resurgence of inflation in the future. In combating inflation in the past, undue reliance has perhaps been placed on

monetary policy. I can readily agree with those who would have fiscal policy, with all of its powerful force, carry a greater responsibility for combating inflation, and I am encouraged to think that this may be likely in the future. If we do this, we should more nearly achieve our over-all stabilization goals, along with some reduction in the range of interest rate fluctuation.

That, however, is a matter for another day. Today, we have in this country a serious problem to contend with in the erratic but persistent rise in unemployment that has taken place since mid-1960. In January, the seasonally adjusted rate of unemployment was 6.6 per cent of the labor force, the highest percentage since 1958; the actual number of persons unemployed was 5.4 million, the highest number since the days before World War II.

The contracyclical operations that the Federal Reserve is and has been conducting, despite the handicaps imposed by the balance of international payments difficulties that we hope will be overcome, should be helpful, as they have been in the past, in combating that part of unemployment caused by general economic decline. Certainly we mean them to be.

While the unemployment that arises from cyclical causes should prove only temporary, there are, however, forces at work that have produced another, structural type of unemployment that is worse, in that it already has proved to be indefinitely persistent--even in periods of unprecedented general prosperity.

The problem of structural unemployment is manifest in the higher total of those left unemployed after each wave of the three most recent business cycles, and in the idleness of many West Virginia coal miners, Eastern and Midwestern steel and auto workers, West Coast aircraft workers, and like groups, in good times as well as bad.

To have important effect, attempts to reduce structural unemployment by massive monetary and fiscal stimulation of over-all demands likely would have to be carried to such lengths as to create serious new problems of inflationary character--at a time when consumer prices already are at a record high.

Actions effective against structural unemployment and free of harmful side effects therefore need to be specific actions that take into account the who, the where, and the why of unemployment and, accordingly, go to the core of the particular problem.

Analysis of current unemployment shows that, in brief:

1. The lines of work in which job opportunities have been declining most pronouncedly for some years are farming, mining, transportation, and the blue collar crafts and trades in manufacturing industries.

2. The workers hardest hit have been the semi-skilled and the unskilled (along with inexperienced youths newly entering the labor market). These workers have accounted for a significant part of the increase in the level and duration of unemployment. Among white collar groups, employment has continued to increase and unemployment has shown little change even in times of cyclical downturn.

3. The areas hardest hit have been, primarily, individual areas dependent upon a single industry, and cities in which such industries as autos, steel, and electrical equipment were heavily concentrated.

Actions best suited to helping these groups would appear to include more training and re-training to develop skills needed in expanding industries;

provision of more and better information about job opportunities for various skills in various local labor markets; tax programs to stimulate investment that will expand work opportunities; revision of pension and benefit plans to eliminate penalties on employees moving to new jobs; reduction of impediments to entry into jobs, and so on. Measures to alleviate distress and hardship are, of course, imperative at all times.

In some of the instances cited, the primary obligation of the Government will be leadership, rather than action, for obviously a major responsibility and role in efforts to overcome unemployment, both cyclical and structural, rests upon management and labor.

For our part, we in the Federal Reserve intend to do our share in combating the cyclical causes of unemployment, as effectively as we can, and in fostering the financial conditions favorable to growth in new job opportunities.

Meanwhile there is, I think, need on the part of all of us to recognize that the world in which we live today is not only a world that has changed greatly in recent years, but also a world that even now is in a period of further transition.

In economics and finance, no less than in other relationships, the lives of nations and peoples throughout the earth have been made more closely inter-linked by developments that have progressed since the beginning of World War II--inter-linked at such speed, in fact, as to outstrip recognition.

Today, the condition of our export trade, from which a very large number of Americans derive their livelihood, depends not only upon keeping competitive the costs and prices of the goods we produce for sale abroad, but also upon the prosperity or lack of it in the countries that want to buy our goods.

Whether our Government's budget is balanced or not, a factor that greatly affects our economic and financial condition, depends not only upon our own decisions respecting expenditures and taxes, but also upon decisions by governments abroad as to how far they will share the costs of mutual defense and of programs to aid underdeveloped nations of the world. The decisions those governments make affect, in turn, their budget positions and, through them, economic and financial conditions in their own countries.

Every country, of course, will always have problems of its own that differ from the current problems of other lands. Communist Russia, for example, gives some signs of worry over a problem old and familiar to us and to them: The danger of economically destructive inflation. The New York Times of January 30 reported that Premier Khrushchev, in a recent public speech, had pointed to precisely that danger, noting that "the purchasing power in the hands of the Soviet people might exceed the value of the goods available for them to buy."

In Brazil, a new administration is seeking means to cope with an inflation that already has exacted an enormous price in suffering inflicted upon her people by soaring increases in the cost of living.

In Belgium, a program of austerity, to bring about adjustments made necessary by the loss of the Congo, provoked riots that recently made headlines across the United States.

In the Free World, the United States has not been alone in finding that its domestic situation and balance-of-payments position seemed to call for conflicting actions, thus presenting monetary and fiscal policy makers some complicating cross-currents.

On January 19, for example, the German Federal Bank reduced its equivalent of our discount rate and made known at the time that it was doing so, despite the high level of activity in the German economy, for the purpose of reducing a heavy and troublesome inflow of funds from other countries. A month earlier the Bank of England had reduced its bank rate also, to curb a short-term capital inflow.

Over the last weekend, Germany and the Netherlands up-valued their currencies by nearly 5 per cent; these actions should help them to reduce the inflow of volatile capital.

The truth of it is that the major countries of the Western world, after a long and painful struggle in the wake of World War II to restore convertibility of their currencies, and thus to lay the necessary basis for interchanges that can enhance the prosperity of all, have succeeded--only to find that success, too, brings its problems.

Today, though currency convertibility does in fact make possible an expanding volume of mutually profitable interchanges among nations, it also makes possible dangerously large flows of volatile funds among the nations concerned--flows on a scale that could shake confidence in even the strongest currencies, and cause internal difficulties in even the strongest economies.

To the causes of these flows--differences in interest rates, conditions of monetary ease or tightness, budgetary conditions, and developments of any kind that raise questions and doubts about determination to preserve the value of a country's currency--we must remain alert and ready, willing and able to meet whatever challenge arises.

I, for one, am confident that we will meet such challenges as may come. Our opportunities for the future are more important than the problems they bring with them. Let us seize these opportunities, firmly and without fear.