For release at 10:00 a.m.,
Eastern Standard Time,
Tuesday, April 11, 1961

Prosperity for Free Men

Remarks of Wm. McC. Martin, Jr.

Chairman, Board of Governors of the Federal Reserve System

before the

Annual Meeting

of the

Association of Reserve City Bankers

Boca Raton, Florida

April 11, 1961

It is always a pleasure for me to have an opportunity to visit in Florida and it is particularly pleasant to visit with such a congenial group as the Association of Reserve City Bankers. Thank you for asking me.

At the outset, however, I want to make clear that I am not here for the purpose of making any business predictions nor even forecasting what the level of interest rates may be a year from now. My concern is with basic principles and the application of those principles in such a way as to get the most and best out of the American economy, whose capacity and future no one can seriously doubt.

The strength of this economy, we all recognize, is based on the market system. It is founded upon concepts of private property, competitive enterprise, and the profit motive.

Experience has, in my judgment, pretty well demonstrated the reliability of the market system as a means of directing human effort--voluntarily, rather than by compulsion--to the task of achieving a higher standard of living for all. The more we can do to increase the breadth, depth, and resiliency of our markets, to use a phrase with which some of you have become familiar as a result of our frequent discussions of open market operations in Government securities, the better off all of us will be.

Certainly if the Western world is to have the economic growth and strength which is required to meet any threat that may be posed by the

Communist bloc, we who inhabit the free world must do everything in our power to organize the resources of our communities in such a way as to maximize their combined economic potential. If we are to resolve permanently the balance of payments difficulties on which we have achieved a measure of progress over the past few months, and to play fully our role in the development of wider world markets, we must accept external competition as a challenge to be met on the time-honored basis of working more efficiently to produce goods and services at prices which people are willing and able to pay.

This, I recognize, is harsh doctrine to some and obviously a hard road to travel under some conditions. But the goals to be achieved are unlikely to be gained in any other way.

Let all of us, in the banking community, in Government, and in labor and management in every field of endeavor, accept this challenge. Throughout our country, we must not only increase our productivity but also pass some of the gains on to the consumer in the form of lower prices rather than having all of it go exclusively to labor in higher wages, or to management in higher profits. By this means demand can be stimulated to provide more jobs for those who are now unemployed, and to keep the economy moving to higher levels, and still greater job opportunities in the future.

Now one of the most visible and striking changes in the world of our time--and this is what makes the problem urgent--is the steady shrinkage of space.

Already, a globe-girdling network of fast air transport is binding our planet's three billion people together so closely that the word "stranger" has diminishing significance. The earth has been compressed into a neighborhood of some 120 nations.

Yet even by the biggest and fastest jet airliners, it still takes more than six hours to transport 125 people across the Atlantic. But by cable, it is possible to transfer 125 million dollars across the Atlantic almost instantly.

More important than the speed of a cable transfer, however, is the readiness with which the currency of one country can now be exchanged for that of another. For now that dollars, pounds, francs, marks, lira and yen can be exchanged almost as readily as a ten dollar bill for two fives, the financial linkage of the free countries of the world has, in a broad sense, been completed.

The implications of that fact, to which we as a nation only recently have been awakening, are enormous in practical significance. It means that in commerce and in finance Americans are in competition not only with each other but also with the world; in competition not only for goods and services but also for capital funds; in competition not only in design, quality, promotion and credit terms but also in prices; in competition not only as sellers and lenders but also as buyers and borrowers. These things haven't come about overnight, and they didn't "just happen" by accident.

Soon after World War II we began to give generous aid to the war-devastated countries to help clean up the ruins, rebuild homes, factories, transport facilities in order to restore those countries to the family of self-supporting nations. They did the work of reconstruction; we supplied some of the materials and tools.

In the course of time our aid programs bore fruit. The war-torn countries took on a new appearance. They changed from paupers to producers, from debtors to creditors, from borrowers to lenders, from aid to trade.

As they prospered they produced more and consumed more, got their finances in order, expanded their foreign trade, and created the means and opportunities for a freer flow of funds across their borders.

All these developments were rightly hailed as necessary steps toward world-wide economic rehabilitation. By the same token, our own role in international affairs has shifted. We are now in a new era of vigorous competition and new problems are an inevitable by-product.

In ten of the past eleven years we have been running a deficit in our international balance sheet. That means we have been spending, lending, and investing abroad more than foreign countries have been spending, lending, and investing here.

As long as the yearly deficit was of modest proportions there was no cause for alarm, but in each of the past three years--although for most of that period exports exceeded imports--the deficit ran well above $3 billion.

The international flow of goods and services and capital is a two-way street, and the traffic is mutually advantageous to all participants. It will benefit us as well as the rest of the world to expand the flow. One of the worst things that could happen to compound our balance-of-payments difficulties would be to adopt a restrictive trade and investment policy. It would wipe out the hard-won gains of years of effort to promote freer international exchange. The more we trade, the more we prosper. The less we trade, the less we have.

With European countries almost fully restored and with Asiatic and new African nations striving for better standards of living, we simply must recognize that we are living in a more competitive world. The way out of our troubles is not to draw into our shells, not to fence ourselves in, but to summon our strength, to launch out, to engage in the competitive fray for all we are worth.

Meeting the competition of the world requires of Americans initiative, imagination, inventiveness, enterprise, managerial skill and self-discipline, both in our private and in our governmental processes.

In domestic and foreign markets, we are going to have to come up with the right goods and services, at the right places, in the right times, with the right prices.

We cannot afford to be priced out of the market by the wage-price spiral: in our private enterprise, employers must remember they are competing with other employers over the world for sales and profits, and employees must remember they are competing with other workers over the world for jobs as well as wages.

Neither can we afford to be priced out of the market by currency inflation: in our governmental processes we must guard against reckless budgetary and monetary practices that can undermine the value of our currency, and with it undermine our competitive position as both sellers and buyers of goods and services throughout the world.

In short, solution of our balance-of-payments problems requires energetic private competition in an environment of appropriate fiscal, monetary, and wage-price policies. This does not mean, of course, that the economy be kept under constant fiscal and monetary restraint. For some time now we have had to face a serious unemployment problem at home, along with a deficit in the balance of payments.

Very early in 1960, well over a year ago, the Federal Reserve launched upon a vigorous program of actions to buttress the economy against weaknesses that were to become increasingly evident after mid-year. In March, the Federal Reserve System's open market operations began to bolster the lending capacity of member banks by reducing the borrowed portion of bank reserves. Between March and July, with business on the decline, some $1.4 billion of additional reserves were provided to induce an expansion in bank credit and the money supply. Early in June, and again in August, discount rates were reduced. Between August and December, nearly $2 billion of vault cash was made eligible to be counted as reserves and still more reserves were provided by open market operations.

Some measure of the effectiveness of the foregoing actions by the Federal Reserve is recorded in the dramatic change that took place in bank reserve positions. At the beginning of 1960 member bank borrowings were $400 million more than their excess reserves. Now they have 500 million of free reserves. Moreover, we have been able to sustain a high rate of increase of bank credit, based in part on growth of time deposits. Total bank loans and investments at the end of February were $12.8 billion above the level of February 1960.

Nevertheless, the task of engineering monetary ease was increasingly complicated during 1960 by an outflow of short-term capital which intensified the balance-of-payments problem of which I spoke earlier. An important cause of the outflow was the disparity between short-term interest rates in this country and short-term rates abroad.

Abundant liquidity prevailed on this side of the Atlantic, where slack business conditions and lack of demand for funds caused short-term interest rates to decline. We were out of phase with high levels of business activity prevailing on the other side of the Atlantic where there was a vigorous demand for funds and consequently high short-term rates of interest, particularly in Germany and the United Kingdom. Under those circumstances, substantial amounts of liquid capital flowed overseas to take advantage of better returns. The continuing accumulation of foreign claims on American dollars and the outflow of gold reached a stage where confidence in the American dollar was being questioned in overseas financial centers and it gave rise, as you may remember, to a short but dramatic speculative upbidding in the price of gold on the London market last fall.

This conjuncture of events, domestic and international, forced the Federal Reserve System to confront a difficult dilemma.

During the latter months of 1960, economic recession at home called for increases in bank reserves to foster expansion of bank credit as a recovery measure. If we supplied these reserves by purchasing Treasury bills, in which our open market operations had been concentrated for several years, the direct impact of our purchases might drive short-term rates so low as to encourage a further outflow of funds to foreign markets, aggravating the balance of payments problem.

Thus, the Federal Reserve began, last October, to provide some of the additional reserves needed by buying certificates, notes, and bonds maturing within 15 months, somewhat longer than the 12-month limit we had usually held to prior to that time.

Then, on February 20 of this year, the Federal Reserve began to buy securities having maturities beyond the short-term area.

The two-fold purpose of this new practice of operating in all maturity sectors of the Government securities market is to see whether we can provide reserves necessary to stimulate business without fostering further outflow of liquid funds.

Some people have said, "You are trying to make water run downhill in one direction and uphill in another. It can't be done." Quite frankly, nobody can be sure as yet how much can be accomplished by these operations. But the problem is there, and we must make every effort to solve it. That we intend to do.

Since the Federal Reserve instituted its all-maturities procedure seven weeks ago, there has been, quite naturally, considerable discussion about the procedure itself and still more about its results to date.

In much of this discussion, it seems to me, there has been a mistaken over-emphasis placed upon the levels of interest rates, as if some particular levels of rates could be in themselves an objective of monetary policy.

That is not the case. What the Federal Reserve is seeking to do is not to set some particular level of rates for either short or long term securities, but rather to influence the flow of funds in international and domestic channels.

The progress of its efforts, therefore, cannot be measured merely by matching the level of rates prevailing at any given time with the rates prevailing just before transactions were extended to all maturities.

To me, it would appear, the best gauges of that progress are these: in respect to short-term rates, whether the outflow of funds to foreign centers is being stemmed; and in respect to long-term rates, whether the flow of capital into productive investment activities is being facilitated.

To anyone surveying developments in recent weeks certain things will be apparent.

On the international front, despite some turbulence in foreign exchange markets following revaluation of the German mark in early March, speculation against the dollar has quieted.

It would be foolish, however, to presume our troubles on this front are over. The fact remains that currency convertibility makes it possible, at any time, to have dangerously large flows of volatile funds in international finance--flows on a scale that could shake confidence in even the strongest currencies, and cause internal difficulties in even the strongest economies. To gain and hold the world's confidence in the dollar, we are going to have to remain on guard against 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 our currency.

On the domestic front, there is evidence that funds are beginning to flow somewhat more freely into activities that may help to spur expansion of the economy. Record highs have been registered within the last month in the number and dollar volume of proposed corporate security flotations submitted to the Securities and Exchange Commission. The total of flotations planned by state and local governments for the month of April, after a sharp rise in March, adds up to one of the highest monthly figures for recent years.

Meanwhile, market yields on long-term securities have been steady, at levels appreciably below the highs of a year ago, in the face of developments that often have produced higher interest rates in the past. Among these developments have been some widely publicized predictions of an economic upturn which appear to have given a boost to general expectations; also, there has been an increase in international tensions. Many of you will recall that in somewhat similar circumstances in mid-1958, the securities market experienced a drastic price decline and a sharp rise in interest rates.

In mentioning these developments, I do not--emphatically not--mean to claim great accomplishments for the Federal Reserve. We have played a part, but that is all.

Furthermore, I would hope that it would be clear to everyone by now that we have never intended to try to establish an arbitrary rate level. Instead, we have recognized from the beginning that the effectiveness of Federal Reserve operations depends heavily upon the reactions of investors. Also, that investors are very likely to react adversely to attempts to set rates arbitrarily, and hence are likely to make any such attempts self-defeating by moving their investments elsewhere. In our country, the Government cannot compel anyone to invest or lend his money at rates he is unwilling to accept, any more than it can compel anyone to borrow at rates he will be unwilling to pay. That is a fact that no public authority can ever afford to ignore.

What we have been trying to do is to operate over a wider range in the execution of our transactions, and thus to register more speedily in the various maturity sectors of the market whatever direct impact our transactions can make. But our operations have been within the framework of a free market. We have respected the freedom of investors to decide what they wish to do, and the necessity that the market remain basically free to reflect the underlying forces of general supply and demand that mainly shape both the trend of interest rates and the flow of funds.

At the momemt, we have pressing need to reduce unemployment and to promote economic growth at the maximum sustainable speed.

In March, the number of persons holding jobs totaled 65.5 million, a record high for that month. But another 5.5 million, constituting 6.9 per cent of the labor force, were looking for work in vain. Not since World War II had so many been unemployed at that season.

Getting these people into active, productive work will require comprehensive efforts, on several fronts, for we will need to press forward--simultaneously--against differing causes of unemployment.

Against cyclical unemployment, which arises from contraction of over-all demand, the Federal Reserve has been and is striving--with an assist now from fiscal policy--to give stimulus to the economy.

But there is another front on which specific actions in supplement of monetary and fiscal operations are needed if we are to deal effectively with the unemployment problem without at some point risking harmful side effects as, for instance, the touching off of a new wage-price spiral.

My reference now is to structural unemployment, which arises from changes in technology, shifts in consumer preferences and in defense production requirements, depletion of resources, relocation of plants, and so on.

A major difficulty in getting workers displaced by such developments into other jobs is that their skill, education, training and backgrounds are not generally those required in expanding activities. But we can help them to overcome that by providing them with educational and training programs, better information about job opportunities, revision of pension and benefit plans to eliminate penalties against movement to new jobs, and reductions of impediments to entry into jobs, along with tax programs to stimulate investment that will expand work opportunities.

In some of these instances, 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.

The Federal Reserve intends now, as in the past, to make vigorous use of its monetary powers in order to contribute to the attainment to conditions conducive to a productive, actively employed, steadily growing economy with relatively stable prices.

But clearly those conditions cannot be provided by monetary policy alone. Help is needed, especially in directly attacking some of the problems of unemployment that cannot reasonably be solved by credit measures. Without such help, we might find at some point that the plague of unemployment was still with us, but by then it had been compounded by inflation.

What is needed, in my judgment, is a judicious blend of specific actions, well-balanced monetary and fiscal policies, and wage-price policies fitting to a vigorously competitive market structure.

In such a setting, the Federal Reserve System would be able to carry out its operations more effectively, and at the same time with greater moderation in respect both to easing and to tightening credit conditions. In consequence, swings in interest rates and in bond prices should likewise prove more moderate.

And in such a setting, conditions would be ripe for the type of demand-expansion I mentioned at the beginning of these remarks: a demand-expansion built upon provision of better value through passing some portion of productivity gains to the consumer in the form of lower prices, and a demand-expansion further fostered by active American trade in widening world markets.

In my judgment, there is no surer path than this to an enduring prosperity, in which all free men may share. If we actively pursue this course no threat the Communists may produce will seriously endanger our security.

---0---