THE ROLE OF THE FEDERAL RESERVE SYSTEM

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CONTENTS

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ADMIRAL HAGUE: We are very fortunate in having this morning as our speaker Mr. William McChesney Martin, Jr., Chairman of the Board of Governors of the Federal Reserve System, who will tell us something about the operation of that system and its place in the operation of our economy.

Economics is not one of my strong points. I remember when I was taking my college course in economics it was explained to us carefully that the difficulty with the old national bank-note system was that when business was humming and tax revenues were rising and the national debt was being reduced the amount of money in circulation was automatically reduced, which put a crimp in the expansion of business, and vice versa, and that the Federal Reserve System, which was somewhat new in those days, was a very cleverly conceived, wonderful device which would put an end to all of our business troubles.

Just what happened in 1929 I am not prepared to say, but it was realized that it was unfair to blame the wrecked turbine on the valve when it was the over-speed regulating device that had carried it away. Certain it is that the Federal Reserve System is a vital part of our economy. It is a most important and influential part of the operation of our economy, and it behooves us to learn all we can about it.

As I said in the beginning, we are fortunate in having the one best authority in the country to speak to us this morning. Mr. Martin, it is a great pleasure to again welcome you to the Industrial College.

MR. MARTIN: Admiral Hague, Gentlemen: I have attended a good many lectures on money and banking in my time, and it seems to me I have always gotten the most out of something which gave me a few broad ideas upon which I could do the research work necessary to get abreast of the technicalities of the subject.

I will try to deal today with fundamentals instead of technicalities for that reason, and also for the reason that too frequently we get immersed in technicalities--technical points about the gold standard, or what reserve requirements ought to be--and completely lose sight of the relationship of money and human factors.

We all know that the Federal Reserve System is here to regulate the money supply. Its purpose, simply stated, is to facilitiate--not establish, for you can't do that, but to facilitate high level employment, stable values, and a rising standard of living: in other words, the objectives of a going and developing society.

In approaching all of these problems we have to realize that economics is not an exact science. It is, in part, sociology and psychology: it has to do with the reactions of a multitude of individuals--with human factors. I think you've got to keep that in mind if you are thinking of problems of high level employment and the satisfaction of the needs of the community, and if you are going to get any real value.

Now what about money? The simple definition of money that we get in textbooks is that it is a medium of exchange and a standard of value, and it has a basic component of confidence. Let's not forget that human factor: its basic component is always confidence. For we can talk about the gold at Fort Knox and how it should be counted and so on, but all of us know that what matters more than whether the gold is really there is whether people have confidence in the makeup of the currency which rests upon it. At least it matters more when we are dealing with the fundamentals rather than with accounting procedures and technicalities.

I can't help but interject here a little experience I had when I was in the Treasury a few years ago and which I have enjoyed a good bit. It has to do with how seriously you can take yourself on some of these subjects and miss the whole point. Shortly after I went to the Treasury, the Secretary asked me if I would go down to Florida and pinch-hit for him in an address to a group in the Florida Bankers' Association who were a little disturbed about the way things were developing in 1949.

With some trepidation I undertook the assignment. I arrived in Florida and at breakfast I was thinking about what I might say, and I felt very discouraged about the outlook of the world. It seemed to me that the problems were utterly insoluble and that it was ridiculous for me to stand up before a group of men as an authority on the economic trend.

I recalled a course in public speaking I took a good many years ago, where one of the lectures was patterned around a prototype of what a responsible government official should say to a group of distressed business men. The general pattern given was that one should always start by saying, "These are the most difficult times we have ever been living in. These are times of unparalleled danger. Never has the ship of state been so close to the rocks." Then you proceeded, by the clarity of the solutions that you suggested, to lead your audience to feel subconsciously that, after all, the ship of state was in good hands and that perhaps we could pass by the reefs and carry on.

I was taking myself rather seriously. I proceeded with just one line of that prototype and, when I had made my suggestions and put in my admonitions and exhortatory comments, I thought I had done a pretty good job. After it was over, a little fellow came running up to me at the side of the platform and grabbed me by the hand. I thought he was going to say, "That was a good talk you made." Instead, he said, "I have to talk to you; it is really important." I said, "All right." "You see," he said, "before I came here I was pretty upset. But after you got through speaking, I was scared to death."

I think that story in a way illustrates how we have to have perspective and balance and judgment in all of these things, and how economics as a science, in so far as it is that, has to be related to this human element of confidence.

Now, why do we have a Federal Reserve System today? Unless you think of it as an evolution, you are missing a major point. No modern country can have stability and progress without some basis of sound currency. That is why all modern countries have central banks. The United States central bank is the Federal Reserve System. Why is it in the form that it is? We all know we had the first bank of the United States and the second bank of the United States, and the sub-Treasury System, and in 1913 we got the Federal Reserve Act. Why did that come about? It came about after a succession of monetary panics, disasters, due largely to insufficient money. For anyone who is deeply interested in the subject, the hearings in connection with the establishment of the Federal Reserve System are among the most interesting that anyone can read, because they show an effort on the part of a democracy to find the means of getting a new type of central banking structure within a democratic framework.

After a long debate, taking into consideration the wide areas of the United States and the local and regional problems involved, we came up with a regional system coordinated by a national governing body in Washington. It is unlike the Bank of England, the Bank of France, and the Bank of Italy, where you have a single bank with numerous branches, with centralized authority usually in the governor of the bank-- the Governor of the Bank of England, the Governor of the Bank of Italy, etc.

The American theory was that the Board of Governors of the Federal Reserve System would be a central coordinating body, an institutional device where, instead of having the governor of the central bank, which I would be under the English system, we would have a Board co-equal with me, of which I would be the Chairman, which would be institutionally the Board of Governors of the Federal Reserve System, and that we would link private and public finance through instrumentalities throughout the country.

So we have twelve regional banks and those regional banks have 24 branches. The banks of the country own the stock of these regional banks, but that ownership is not a proprietorship--it is only a device for participation in the modus operandi, and I am deliberately using that term rather than "management"--of the Reserve Banks, because the Federal Reserve Act placed management in the Federal Reserve System.

We merge public and private participation by having for each Federal Reserve Bank a Board of Directors. There are nine directors in each bank. Three of them are Class A directors elected by the banks that own stock. Of these three, one is chosen by the large member banks, one by the medium-size banks, and one by the small banks. Then there are three Class B directors, also elected by the banks, who come from the business, agricultural, and industrial interests of the community but who cannot have any connection with a bank. The other three directors are appointed by the Board of Governors of the Federal Reserve System in Washington. In other words, the majority of six are in the private-public realm--three are appointed from Washington, and one of this last group is named the Chairman of the Board for his Reserve Bank by the Board of Governors here in Washington.

So you have a blending there of the public interest and private business.

Now, the Board of Governors of the Federal Reserve System is clearly a government operation, a government institution. The individual Reserve Banks are semi-government; part government, part private, and the democratic device of having the directorship determined in part by the banks that own the stock in the Reserve Banks has on the whole worked out reasonably well in the roughly 40 years of the Federal Reserve System's existence.

Why did we have the Federal Reserve System as such? We had it because, remembering 1897, and more particularly the money panic of 1907, the country was fed up with recurring money panics. Whenever money was most needed, it disappeared; whenever it was least needed, it was abundant. The same was true for bank reserves throughout the country. Whenever bank reserves were unnecessary, they were plentiful; whenever they were necessary for the business community in general, they tended to disappear, because they were scattered and there was no way of mobilizing them.

So the two basic defects in our money situation in 1906 and 1907, crystallizing in that panic of 1907, were, as we call it in technical terms, the inelasticity of the currency and the scattered reserves for the banks as a whole. Since the Federal Reserve System came into being, we have virtually eliminated the problem of elasticity of the currency. In fact, today it works so well that you never hear of any currency shortage, except in the case of the nickels, dimes, or quarters which have not been turned out by the mint fast enough; where the flow of the currency from one section of the country to another has been delayed by the mail; where currency has accumulated more rapidly; or in a period of mobilization where there is an increase in the currency in circulation and the manufacture of the money is delayed by not having sufficient manpower at the Bureau of Engraving and Printing.

The elasticity of the currency has been pretty well established. There is hardly any one in this room who can remember a time when any one had difficulty getting his needs. The other thing which was corrected was the immobility of bank reserves, which was more fundamental. It was something more than correcting the inability of banks to get reserves when they were needed, because with the correction went power for the Federal Reserve System actually to create money.

Within the limit of the statutory requirements that liabilities of the individual Reserve Banks on notes and deposits can never exceed four times their holdings of gold certificates, the Federal Reserve System can create reserves for the member banks at any time it wishes. And in that ability to create or extinguish reserves lies the essence of what is our modern regulation of the money supply.

Why that is important to us gets back to the real crux of our problem, which is the purchasing power of the dollar. There is not any one in this room who has not heard it said that we have now a 55-cent dollar or a 65-cent dollar, or that "the almighty dollar is not what it used to be." This is a phrase that has been developed in the last ten or twelve years, and the public's concern over shrinkage in the dollar's purchasing power unquestionably played some part in the thinking of both political parties in the last two years because, when the shrinkage reaches those proportions, it begins to strike at the interests of all people, rich and poor alike. You can't, you mustn't, exaggerate the role of money in this picture, but you also must not underestimate it, because regulating the money supply, if done capriciously or without regard to the forces of the market, interjects into the picture an artificial element which cannot help but produce a certain amount of inflation.

Most of the countries of the western world have been experiencing inflation, based in part upon improper monetary policies--in my judgment. More recently, many of them have, through the hard, painful process of devaluation, as in the case of Britain, or by a reversal of policy, swung back to more orthodox means of controlling the supply of money; not because they have turned to the right as a political trend, by the way, but because attempting to eliminate the law of supply and demand had not worked. After all, it is a workable system we are after. It is when the system doesn't work that the political pressures get so great that they produce a reversal.

Now the heritage of all war is inflation. I don't have to tell that to you gentlemen. I remember well when I was first down in this building in the 1941 period. We could see the inflation of the United States developing and then, in 1942, we had an agreement of the Treasury and the Federal Reserve Board to inflate the money supply deliberately.

I can't remember everything I meant to look up precisely for you. Don't hold me to these figures exactly, but, roughly, the cost of the war from 1940 to 1945, the dir ct cost of the war, was in the neighborhood of 380 to 400 billion dollars. We raised about 150 to 160 billion of that in taxes. We sold about 130 to 135 billion dollars worth of savings bonds and other bonds to nonbank investors. The balance of that expenditure was financed by bank credit. Bank credit in the total ran to about 100 billion dollars, and by 1945, by the time I entered the Treasury in 1945, we had an increase in total deposits and currency in the neighborhood of 110 to 115 billion dollars. The exact figures are in my office. Those are approximately correct.

That is an enormous addition to the money supply. Whether it would have been wiser, or would have been possible--which is more important--to have financed a greater proportion of the war out of taxation, or to have sold more bonds to nonbank investors, is all water over the dam and of little importance to monetary policy or the role of a central bank today. The fact remains, we had an inflated, swollen money supply at the end of the war. That was true in all countries of the world.

Let me say here that I doubt if we could have financed World War I, and, to a lesser extent, World War II, without the Federal Reserve System. Of World War I, I am sure. In World War II we might have had a little different system if the Federal Reserve System hadn't done it, but nevertheless we used the Federal Reserve and it was the framework on which we were able to make the inflation of the war supportable. You can restrain inflation in a period of war, as in no other time. You can control these forces of the market when people have a sense of urgency, when people are willing to pay the price, when you have the support of public opinion.

After the war, there was a different atmosphere, a lessening of the sense of urgency. But there were still problems, and countries over the world began to engage in one palliative or another, to see what they could do to keep the law of supply and demand within balance. In Britain, the Government determined that it would follow socialistic policies--it would plan in a large measure how each division, such as the division of labor, would be determined by government precept. On the whole, they were not entirely unsuccessful, but the problem got greater and greater, more and more difficult. For instance, maintaining exchange controls, an important aspect of Britain's problem, went from more and more difficult to well nigh impossible. By early 1949 it was perfectly apparent in England that either they had to deflate internally or they would have to devaluate their currency. Deflating internally was too difficult a political problem for the Government to handle: they took the easier course of devaluation. Gradually, as the foreign aid from the United States has been slowing up, the British have been coming more and more to the recognition that they do have internal inflation and that they can't expect to have a sound external balance of payments unless their internal finances are on a sound basis also. So they have been driven perforce back to recognition that while you can plan, you cannot always ordain.

I don't want to be misconstrued in anything I say or to have you assume that I believe in laissez-faire economics or that you can go back to the rule of the jungle and have a market place without rules and regulations. I think that time has passed. In the evolutionary process involving the use of money, for example, we found from experience, over a course of time, that (1) the rigidity of the old fashioned gold standard got too great, and (2) the hysteria that developed out of it got unmanageable. So we cut loose from it. Then the Federal Reserve Act itself was in part an adjustment in economic terms.

Now, you have heard a great deal about direct and indirect controls. That has become almost as debatable a point as a sales tax, for example. Many people ascribe to direct controls all sorts of virtues that I doubt ever have existed. Controls put human nature in a straightjacket. There are many ways you could determine policy with respect to controls, but I think in this field extremes, on all sides, are wrong.

I used to abhor the "middle-of-the-roaders," but I have come to the conclusion that in the field of monetary policy you have to get some place in the middle in a world with th conflicting forces that we have today, and with problems that you gentlemen are much more competent to pass on than I am. In economic questions, the one man I really fear is the man who is sure he has the answer. I am very much convinced on that, because there is no field in which people get more zealous-- such as the man who says, "If we could just return to the old fashioned gold standard all our problems would be solved; if we could just manage our money supply on a direct-line basis, the problems of demobilization and everything else would be solved."

Since I have been in the Treasury and in the Federal Reserve System I have been fascinated at the number of people who get very close to being crackpots in their zeal. I am not trying to make fun of them, but they see a simple solution in something that is only an incidental, a by-product. I don't want to minimize the importance of monetary policy. I believe monetary policy is indispensable to the functioning of any free society, though I know it is considered dispensable to the functioning of a non-free society, as they have in Russia. I learned that when I spent a little time in Russia in 1943. I was fascinated with the lengths to which they were going in Moscow at that time to put their monetary system on a totalitarian basis. At that time, if I understood it correctly--I always hesitate to speak like an authority on the Russian picture, for I am not, even though I did my best in three months in Moscow to find out what I could find out about the way they were operating their system--it worked like this:

If you got X rubles for your services, you deposited X rubles in the bank--and a check was made on whether or not you actually deposited the rubles in the bank. When you withdrew rubles, they had you fill out a survey form telling in a specific way what you intended to do with the rubles. Think of the bookkeeping involved in that! That was the totalitarian approach to the handling of money.

Money is not a cure all. It is one means--at the start I used the word "facilitate" rather than "establish"--of facilitating high level employment, stable values, a rising standard of living. But monetary policy by itself can't do any of those things. You can't make people borrow money if they don't see an opportunity to profit from it. You can't run a deficit in the federal budget of X billion dollars over a period of time and expect monetary policy to make it feasible. You can't ignore your tax and expenditure structure and just "ordain" the components of money, including that component of confidence that I spoke about; it won't work. In my opinion a sensible money policy must be directed consciously toward permitting the forces of the market--by which I mean in a general sense here this morning the forces of supply and demand--to operate. You need the market's objective measures of the forces of supply and demand because you have to have some guide that on the whole is better than the subjective judgment of the Federal Reserve Board or of the United States Treasury, or of any one here this morning. The guide used, it seems to me, must be practicable. I believe that test is met by the composite judgments of the market place in relation to the law of supply and demand in whatever framework a given society is placed. In our society, we still believe in private property, free enterprise, and the profit motive. Those are basic tenets that are part of this loose and sometimes mouthy force we call the American way of life, and of the American economic system. They are inherent precepts concerning the process which has made us the productive country we are and which has given our workers a productivity, based on that philosophy, unmatched elsewhere. If you want to overturn that philosophy and build a new system, you would have to change a great many things--and up to this point we have not done it.

We have tried, and again will try, new things, of course, in monetary policy as well as other fields. Going back some, there was the "New Capitalism" of Theodore Roosevelt. His idea of New Capitalism in monetary policy was making certain adjustments to changing conditions, in the regulation of the supply of money. Then there was what Woodrow Wilson called the "New Freedom." But these were adjustments in our system rather than substitution of a new system or new order.

A part of the New Freedom of oodrow Wilson was the Federal Reserve System. He put that No. 1 in his administration when he came in. The reason he put it No. 1 was because the money panics of 1897 and 1903 to 1907 had undermined the confidence of the people in the currency, in their ability to get it when they needed it, and in their ability to relate their activities to their bank accounts. He certainly, in the Federal Reserve Act, did not intend to violate the principles of the market place; he did not intend to ask for the repeal of the law of supply and demand. He just said that we ought to try to eliminate obstacles hindering operation of the law of supply and demand, to see if we can't devise a means of eliminating these recurring panics and getting a dollar that is stable and within the realm of human availability.

Since Woodrow Wilson's time we have seen distortion in the forces of the market again, and in different ways. In the period of 1928-1929, the money supply got out of hand and an inordinate volume of credit went into the stock market, into speculative activity. I went on the stock exchange in 1931 and the thing that fascinated me was that the forces of the free market were being completely inactivated b y private interests. I used to say I traded in General Motors stock, and I would go over to the corner where we traded in General Motors to find out whether Mr. Durant and his crowd were buying or selling. People were more interested in finding out what executives of the company planned to do about the company's stock than in making judgments for themselves on what the stock was really worth in the light of the company's prospects.

The pool operation, which has been outlawed now, and rightly so, had become a device for destroying the market--I mean destroying the forces of the free market. Of course we don't have freedom in anything in life in a completely pure sense. Your relationship with the community always enters into it--but the ability of the free forces in the market was being completely destroyed by private interests. I was getting disgusted with the operation--not in a moral sense, but in the feeling of: Why should I waste time trading here? If I could get some fellow to tell me what this pool was going to do on the morning of Friday, the 2nd, I could make a few dollars. Sometimes I felt I was bucking up against a hopeless task.

The forces of the free market were being eliminated then in much the same way that the British were trying to eliminate the law of supply and demand in the postwar period by saying: "We will let the laboring man have only so much and the manufacturer have only so much. We will do that by a central planning group under our Ministry of Supply." To put it another way, to illustrate my point: Our Federal Reserve Board over there--we think we are reasonably good; but I can assure you the Federal Reserve Board is not competent to determine what the sources of supply and demand are in the United States--the country is too big. We get, I think, probably as good information as it is possible to get on economic conditions in this country; but even then there is a lot to be desired and, to operate effectually on that alone--without the judgment of a fairly functioning market for guidance--you would have to have real temerity or else you would be arrogantly making decisions which are semi-capricious. No, you wouldn't think them capricious at the time, but they would be.

What the oil man in Texas needs; what the San Joaquin Valley in California needs, is a composite of many judgments, and when it is straight-jacketed too far into a planning operation, it can defeat its own end. I sat on the Mobilization Board over here during the time Mr. Charles E. Wilson--I'm talking about Charles General Electric Wilson--was the Chairman, and I never saw a man work harder or in a more devoted way to handle the mobilization picture than he and the group around him did. I don't for one moment intend to be critical of him. It was perfectly obvious, however--and I think many of you would agree with me--that the country as a whole didn't have a sufficient sense of urgency to comply with a lot of the plans and programs that were being developed.

In the absence of a sense of urgency and willingness to cooperate, price and wage controls and other controls of that type are bound to be leaking at the seams all the time. You can't eliminate that. You are dealing there with the forces of human nature. When a man--any man--can go into a store and ignore or violate a price regulation and nobody feels sufficient urgency or compulsion about the problem to do anything more than laugh at him, although they know he has done wrong, then no group of individuals in Washington, even if they had the Army, the Navy, and the Marine Corps on the track, could handle the problem--not in a country as big as this.

When we come up against these basic forces, we tend to reverse course. Franklin Roosevelt's New Deal exemplified that in a way. Certainly it was a further adjustment from the New Capitalism of Theodore Roosevelt and the New Freedom of Woodrow Wilson. I would insist that the New Deal of Franklin Roosevelt was not intended to destroy private capital, private property, private initiative--though it may have tended to have times of excess, just as there are often excesses in anything new. It was marked, instead, by a desire for adjustment to a number of situations, one of which I highlighted in speaking about the stock market, where the laws of supply and demand, the composite demands of the market place, were being eliminated by private groups of capitalists. But when the problem of labor entered into the situation and the law of the jungle was permitted, the righteous indignation of the body politic rose up and said, "We will have none of this."

You had a large series of alphabet organizations in the Government, one of which was NRA. They went on for a long time, and then folded up. You had a modification of the New Deal by the Fair Deal, and a further growth in Government economic operations. Now we have a new Administration, and a different approach. I wonder whether they can do all the things they hope to do, but this movement they have entered upon has been a very necessary movement if you think of it in terms of a recognition of what our objectives are. Our objectives essentially are to be strong, to maintain our freedom, to mobilize, and to do these things in the most effective and efficient way. It became obvious that we didn't have super men in Washington. We don't even have super men in the Armed Services! We don't have super staffs in Washington. At the Federal Reserve Board we have good, reasonably competent men, but we certainly don't have super men. As I see it -- and I am throwing out an analysis for you to tear apart--the conservative trend of recent years reflects recognition that we are not willing to rely on the decisions of supposed "super staffs," and we are going to return to a free market. That has shown up, in the field of monetary policy, in action taken in Belgium, Italy, the Netherlands, the Scandinavian countries and now, to a lesser extent, in France. In our country, it has shown up in the action of the Treasury and Federal Reserve. I believe that we will--with the sense of urgency in its present state--probably achieve more in terms of mobilization, and probably achieve more in terms of strength, production, and productivity, by letting the composite forces of the market make more of the decisions than they have been making.

Now, if we had a different sense of urgency, such as would come from an atomic bomb dropping out here in the middle of the place tomorrow, the situation would be vastly changed. We would revert almost completely to saying, "We have now a sense of urgency which vitiates the composite forces of the market," and we would take a lot of authoritarian steps which would have the backing of every one, and therefore would be enforceable and workable.

But under existing conditions, I happen to be one of those who believes that the judgments of the market place--when the rules and regulations, like the rules and regulations on a handbill, are known and understood and comprehended--will do more in the way of creating strength and initiative and power than will, on the whole, too much dependence on planning. I am not talking about humanity planning--I am talking about depending too much on decisions of men around the table.

That brings to mind something I was quite interested in when I was in Russia in 1943 and talking to several of their young people. There was one of them, an economist, who kept telling me, "I don't see how you people can permit the freedom that you have in terms of marketing raw materials and allocations." He said, "Of course, that would not work over here." I tried to make the point to him that we could hardly afford not to permit that freedom, because it was the dynamo of our system. I told him we didn't have this freedom because we were absolutely wedded to it as an article of faith, but because we had found it worked better than other systems--that he could see evidence of that for himself in the never ending stream of those jeeps that the Russians admired so much. I told him that this business of depending on the free market was not a luxury; it was a necessity; it was not something you did <u>after</u> you had gotten all of the problems of the world straightened out; it was part of the very process that straightened things out and made for you your strength and your power.

I see I am running a little bit over my time. I am going to conclude by summing up the dilemma--my remarks are entirely nonpolitical--that will be faced by the incoming Administration in the field of business and mobilization. The extent to which the powers that be can lean upon this market in a rational sense will be determined by whether they have the courage to make certain adjustments that have to be made from time to time, or whether they are going to follow the course of saying, "We have to keep full employment at any cost."

We had some hearings that some of you may have followed a year ago, the Patman Committee hearings. The title of those was interesting to me: Monetary Policy and the Management of the Public Debt--Their Role in Achieving Price Stability and High-Level Employment. That was first written "full employment." I think I had a little to do with having it changed to "high level."

The soothsayers and the semanticists will tell you there is no fundamental conflict between full employment and price stability. I happen to be one of those who think that that is not so; that in a competitive society, in a society in the framework of the market place, such as I have sketched, the relationship is direct. Now a lot of people say to you, "We have to face some unemployment. Therefore you are insensitive to the suffering and to the inhumanity and the despair of 1929-1932." I have a tendency to resent that sort of talk. I feel I am a reasonably humane individual. I don't think that enters into it at all. I think capital has a real responsibility for what happened in 1929-1932. That was the law of the jungle that applied. I think intelligence on the part of industry would have minimized greatly the suffering and difficulties that occurred in that period. I think that is where "humanity" comes in. But it is not humanity, this process of saying, "You can't ever have any adjustment; full employment is something that has to be maintained at any cost."

One of the central bank governors of a foreign country, a good friend of mine, told me it got so bad in his country that when anyone became unemployed, someone would run after him with a printing press and inquire whether he lived the same way he lived before.

Let me illustrate what I am driving at. In my judgment, you have to make some adjustments. In retrospect--this is not said in a critical sense--I was in the Treasury in 1949. In that period I saw business men, Republicans as well as Democrats, come pounding down to the Treasury and yelling bloody murder the minute the seller's market began to disappear and the buyer's market began to appear; the political pressures were such that I thought two or three times I would quit the Treasury, that it wasn't worth going through at all. These men were people who said they believed in competitive enterprise, but they were saying, back then, "Don't let it happen to me. You have the government role in here. You can straighten it out."

Labor ought not to be compelled to bear all the process of adjustment, but you can't always have a seller's market. The time has got to come again when the automobile salesman who comes to sell you a car will say, "Yes, sir, good morning! I would like to show you this car." All of us have been through this period when business was not business at all; where you went to look at an automobile which cost three thousand dollars, which you thought was a pretty good expenditure. You went in--of course you are just Joe Smith off the street--and you said, "May I try that car?" They looked at you frigidly and said, "Have we got your order?" You said, "No." Then they said, "No one can drive that car until he has ordered it. We have more orders than we can fill."

A lot of American business has done that. From time to time, the man who has been the most imprudent has made the biggest profits.

That won't always be. You can't always have a seller's market. I remember in the discussions on convertibility of the pound a few years ago, you had a body of people who said, "Of course, the pound is not properly valued. We recognize that; but as long as there's a seller's market, we don't have to worry." A very wise man who attended those meetings, the outgoing Secretary of the Treasury, who was as right as rain on that point, said, "Yes, gentlemen, I will agree with you, and the country may go along with you now, but when the seller's market evaporates where will you be?" That is what happened. The seller's market evaporated. Britain had to enter the competitive market again or die, or have a never ending stream of aid.

There is another fallacy that I have encountered often. People say, "We have to have security." My contention is that the earning process, not the handout, is the important thing. You can keep a person in a hospital a certain period of time, but at some point he has to get out into the world and make his way. I happen to have a friend--maybe one or two of you in this room know who I am talking about; he was pretty badly shot up in the Battle of the Bulge. He was out there at Walter Reed Hospital. He had been flung flat on his face and he was hospitalized. A friend of mine, a doctor, an awfully good fellow, got to talking to him when I was there, and said to him in so many words: "Now, we can always take c re of you. We have a Veterans' Administration in this country, and, until the country collapses, you don't have to worry. But you have reached the point where you have to get up and make the effort to walk or you will be moving from one hospital to another afterwards all your life." Not long ago I played golf with that fellow.

In part, that is the way it is with the money process in the economic supply picture. Don't let anybody kid you on this--in my opinion it is partly a process of faith and initiative and will. It is not something to be doctored by the Federal Reserve Board, or a group of planners; it is the composite of the will of the group. The role of the Federal Reserve System in the regulation of money has to be as little capricious as possible in trying to make adjustments in the money supply. Its proper role is to act, not in accord with the dictates of private interests, or of political interests, but in accord with the market forces; and in that sense, as now constituted, the Federal Reserve System is one of the primary bulwarks of the free enterprise system.

Thank you very much.

MR. MUNCY: Mr. Martin is ready for your questions, gentlemen.

QUESTION: I have a rather administrative type of question to ask, sir. You stated, I believe, that the central bank could extend credit some four times beyond its gold certificate holdings, or something to that effect. What is backing up that credit that is extended there? Is it the Treasury of the United States? Or what is backing that up?

MR. MARTIN: It is the gold reserve.

COMMENT: Yes, sir; but there is over four times as much credit out as they have gold. In case something extreme should happen, who would back that up beyond the gold?

MR. MARTIN: Well, that four to one ratio happens to be the present legal requirement. If something extreme should happen, you would probably change the reserve. It is an elastic operation. It is probably the most difficult thing for any of us to understand what the scope of human psychology on it is. You start by saying: "We did have 40 per cent; now we have 25 per cent in gold." At one point we had a lot of commercial paper in the country. It could be gold, Government securities, or commercial paper. In the framework in which we are operating today, those are the limits. If those limits are exceeded, we would have to take steps to contract.

Now, whether the likelihood of what you are talking about would be mismanagement by the Reserve authorities, if it became too rapid for them, they would have to go to Congress, and Congress would have to legislate a different reserve. It is nothing but a relationship. I am afraid I didn't satisfy you.

QUESTION: Sir, do you believe that the stock exchange now in general operates as a free market?

MR. MARTIN: I don't think you can ever answer a question like that 100 per cent. I think generally it does, yes. On the freedom, there's a level where you can say it is not free for one man to have 20,000 shares of stock, but if you are talking about the forces of the market, I don't think there's any conspiracy, as there was in the pool operations, permissible under present regulations that can't be handled.

We have the same thing in the Government securities market. We have a number of recognized dealers. These are recognized as people who have broad enough coverage to do business in Government securities; but the Federal Reserve has the largest single bond account in the world today, a 24 billion dollar bond account. It makes me tremble sometimes at the size of it. Whether that account is operated capriciously or not is very important to us all--it is a great responsibility that has been placed on the Federal Reserve Board. When I went to the Federal Reserve we were entering upon the period of an unpegged, or free, market for the first time in years, and many people had fears of insecurity, panic, and disturbance. Indeed, the fact that the X Insurance Company was going to have a board meeting at noon would have the market jittery with apprehensions.

Now, in a free market nobody ought to be big enough so that mere apprehension over what he intends to do should completely upset the Government of the United States. Well, we worked it out pretty well with most of the insurance executives. Today they can do anything they please. That is to say, it is a free market.

There is no group more closely tied in with us than the insurance people, because they are selling insurance to hundreds of thousands of individuals and, if it is going to be worth anything when it comes due, the responsibility is going to be partly theirs if they are disturbing the government's security market or making a mockery of it. We ought not to be telling them they can't buy or sell if they want to.

I think the market is free today. Certainly it is free in Government securities.

QUESTION: Would you mind explaining the Government's increasing the rediscount rate to two per cent a short time ago, and also the possible implications of it, whether there is danger because of a deflationary trend?

MR. MARTIN: Yes, I would be glad to. I have to go back a little bit to explain this to you. I think you will see how this fits into the pattern of what I covered in my remarks.

In 1951, following the Treasury-Federal Reserve agreement, we unpegged the bond market. We did not at that time have any deficit financing facing us. We just let the market more or less drift. Then in 1952 we were faced with deficit financing. That worried me tremendously. I thought it might be the spark that would really light the bonfire of inflation. So we had to do everything we could to see that the deficit was financed with funds obtained from nonbank investors. Having freed the bond market about a year earlier, we were in a pretty good position to do it.

I sat down with Secretary Snyder and we came up with a plan for a security offering. We planned a medium-term bond with a yield slightly above the market. We sold the security to nonbank investors. The offering was oversubscribed. The threat of panic disappeared. We had thought that maybe the Federal Reserve would have to supply a large volume of reserves to the market in making the issue successful. As matters turned out, we didn't supply reserves to the market.

The result was that a 2-3/8 per cent issue of some five billion dollars covered virtually the size of the deficit. At the end of eight weeks after it had been offered, the bond fell from a market price of nearly 100-3/4 to below par. The banking system, which originally held only a small part of the issue, bought during the period and increased their Government security holdings substantially. Banks began to be pinched for reserves and the short-term rate rose.

As the short-term rate rose, the banks that had deficit reserve positions found they couldn't restore their balances. It went into billions. You see about as interesting--from a monetary standpoint--a demonstration of the finance of the market forces as I have ever seen in a period. As the borrowing rate got up around 2-1/8 per cent, many companies throughout the country whose treasurers hadn't invested in the money market in years saw this was too attractive to let money lie idle, and they put their funds into Government securities. The result was the actual deposits of the banks decreased as they were under pressure to sell securities that were bought by their depositors. People say, "Those are short-term borrowings; they will come back." That to me is not realistic. They will come back, of course; but at least you put into operation the process of investing those funds. Moreover, the process kept banks under pressure to screen their loans and investments with increased caution.

As time went on, we had been using the discount rate of 1-3/4 per cent as the pivot. The pivot got away from us, and it came to two per cent. These were the forces of the market--not us. We could have stepped in and said: "We will put a discount rate of two per cent, or 2-1/2, or 2-3/4--whatever is necessary to keep interest rates at what we think they ought to be." We are not going to take that responsibility. We are going to let the forces of the market by and large determine that within a general framework of a stable growing economy.

As long as the Treasury bill rate hovered around 1.65, 1.85, or 1.90, there was some relationship to the discount rate. At the end of the year, with a mixed money market we assisted in meeting many special and temporary demands in the financial markets that occur at this season. We always have difficulty at the year end period or at tax payment dates. Our job is to facilitate the transfer of funds; not to just make trouble in the market.

After the year end, however, we saw that it was unlikely that the structure of money rates would go back to a 1-3/4 per cent basis. We then raised the discount rate to 2 per cent. We might have raised the discount rate last September to two per cent and it might have had some restraining effect on the increase of loans that took place in the field. But it would have meant leading the market with the discount change. That was our reason for not doing it then.

I had to persuade the Secretary of the Treasury to jump from 1-7/8 to 2 to 2-7/8 in a period of three months from July to September. Secretary Snyder doesn't like high rates--neither do I, if the market doesn't determine them. That was quite a movement. We felt we ought to go slow, and perhaps a lot of people thought the market might taper off and we would have some contraction.

When General Eisenhower's election came along, there was such a resurgence of business confidence immediately after his election that we knew our projections were not askew. I think the relation between his election and the first of the year was what I call a boomlet, with emphasis on the "let." As to whether the boomlet was sound or unsound, I would not enter into that; but the boomlet, plus the fact that the Treasury had a refunding coming up on February 15, made necessary an adjustment in the discount rate in mid-January. We did not know whether the boomlet would continue at the pace of the last four weeks of the year, but were it to do so it would be unfortunate.

Let me make a point there. I think it is important. None of these decisions is of any value unless it is taken in relationship to projections. It is exactly like the purchase or sale of securities in the stock market. It doesn't do you any good to buy the stock after you know what the earnings are. If you believe Montgomery Ward is in a good earning position, chances are you buy the stock and watch it go up. If you wait until you know for sure you will be too late and may buy right on the top. You have to relate these things to the psychological factors. I don't want to overstress them. In your mobilization work I think it is fundamental.

We probably would not have raised the discount rate except for what happened. I am going to illustrate by one line. In the retail trade in the Christmas period of two weeks there didn't seem to be any price pressure, particularly; there didn't seem to be any inventory accumulation that was excessive. But in the week before Christmas every shelf in the country was wiped out, so much so that the Pennsylvania ran three extra trains full of buyers from St. Louis to New York.

At that point I wanted to raise the discount rate. I said, "These buyers, being human, and having little excess inventory, will now rush down to New York and overstock. They will say, 'We are not going to be caught short again', and they will buy too much. I would like to put up a danger signal to them and indicate if we have anything of the post-Korean sort, we will put the rate up again. We will do it in orderly fashion, after the forces of the market have decided, rather than make a decision. We are going to cut the economy down to size."

There is one other fundamental thing that again is right at the heart of it. Monetary policy in my judgment should never be used to restore the purchasing power of the dollar. Once it is gone, it is gone. Production and productivity are the only ways we will restore the purchasing power of the dollar. People come to me all the time and say, "Why don't you get the purchasing power up to 75 cents again?" I can't do that. I wouldn't attempt it. I would be saddled with responsibility for making adjustments that I don't think monetary policy has any part in.

I want to emphasize again that monetary policy is a minor element, not a major element, in the picture. Its importance comes from the fact that it is indispensable.

QUESTION: How do you think your refunding will be accomplished on the 15th of February? Will it be through nonbank borrowing or bank borrowing? What is your guess on that, or do you know?

MR. MARTIN: I don't know how I would answer that question. Truly, it is so far in Mr. Humphrey's field that I would rather not comment at all. You can see my position.

MR. MUNCY: Mr. Martin, we are deeply indebted to you for clarifying for us, inexpert as we are in the field of monetary financial work, a problem which we have always understood to be extremely difficult. You have made it much clearer for us. We sincerely thank you on behalf of the Commandant and the staff and faculty.

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