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Statement of  
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before the  
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of the Senate Committee on Banking and Currency

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The year 1957 was a difficult one for those of us charged with appraising financial and economic events and formulating appropriate monetary policy. From its opening and on during much of the year, inflationary pressures were dominant in this country and abroad. In commodity markets, industrial prices were continuing to advance despite generally downward reaction in prices of some internationally traded basic materials following the Suez crisis. In consumer markets, prices of goods and services were advancing at a very rapid pace for a non-war period. Prices of common stocks, which had tended down from mid-1956 to early 1957, rose sharply to new highs in mid-summer under the influence of creeping inflation doctrine and of widening confidence that the large capital expansion in which business was engaging would be adequately supported by the demands of a rapidly growing population for a rising standard of living. The strength of inflationary pressures was exemplified by the marked advances being recorded in the gross national product measured in current dollars as compared with the relatively modest gains that were being obtained in the physical volume of total output.

In spite of Federal Reserve actions taken to resist inflationary trends--including six increases of Federal Reserve Bank discount rates in 1955 and 1956 and the pursuance of a restrictive credit policy--money lost its value at a rate that was a matter of great concern to all. Inflationary excesses had clearly gotten ahead of us and the economy stood in danger of an inflation crisis. The adjustment problems that the economy is confronting today are the aftermath of those excesses.

As a nation, we were trying to do too much too fast, and heavy pressure was exerted against the available supply of savings. In retrospect, we underestimated the speed and force of the inflationary boom and the widespread growth in speculative attitudes and commitments. Consumer instalment credit rose substantially in 1955 when terms were sharply relaxed and consumers used credit more freely than ever before in the purchase of record number of new automobiles. Businesses greatly increased their expenditures for plant and equipment. The rise from 1955 to 1956 amounted to more than one-fifth for business as a whole and this advanced level was further exceeded in 1957. Stock investors were too optimistic in capitalizing the income and dividends which this investment might yield. Bankers and other lenders greatly expanded their commitments to lend in these years. Also, liquidity positions of banks and businesses were being reduced as their short-term liabilities were increasing faster than their holdings of cash and Government securities. Labor unions sought wage increases--and commitments for future increases--that pressed against or exceeded gains in productivity. State and local governments borrowed record amounts through the capital markets in an effort to meet the needs of their citizens for community facilities and services.

Inflationary trends continued through the summer months of last year. There was an alarming spread of the belief, not only in this country but also abroad, that creeping inflation under modern economic conditions was a chronic and inevitable condition. Reflecting this view, common stocks, the most popular hedge against inflation, rose

sharply in price in July to a level where for the first time in two decades their yields fell below the yields on high-grade bonds. Also, credit demands generally continued to show great strength, and interest rates were rising. Large city banks on August 7 raised their lending rate to prime business borrowers from 4 to 4-1/2 per cent. In this situation, Federal Reserve Bank discount rates, which were below market rates by a widening margin, were raised in mid-August from 3 to 3-1/2 per cent, thus increasing costs to member banks operating on the basis of borrowed reserves.

In late summer and early autumn, developing uncertainties here and abroad began to affect the short-term economic outlook. In European exchange markets, widespread expectations of changes in exchange rates fostered large speculative movements of funds between European centers. These expectations in part reflected further accentuation of inflationary developments in some key countries, despite actions to tighten credit that were taken in various countries during the summer. It was not until late September, after the Bank of England established a 7 per cent discount rate, that it became clear that key foreign currency values would be maintained and that inflation would be strongly resisted.

In this country, the unexpected curtailment in defense payments and changes in procurement policies that were inaugurated during the summer, partly to avoid breaking through the debt ceiling, had an unsettling effect on business. In September, nonagricultural employment, which had been at a record level in August, began to show signs of slackening. The Board's index of industrial production declined slightly. Reflecting these and other developments, common stock prices in late September broke

through the trading range that had prevailed during the past two years. With changing attitudes toward the economic outlook, production and other adjustments that had been occurring for some months in various lines of activity, including some capital goods lines, came to be reappraised by businessmen, investors, and the public generally. In contrast to earlier indications of strong credit demands, bank loans to business during early autumn decreased contrary to usual seasonal tendencies.

The pace of business was maintained for a time despite these uncertainties. By late October, the composite of most recent economic information suggested that inflationary pressures were abating, and open market operations were modified to lessen restraint on bank credit and monetary expansion. By mid-November, information becoming available, incomplete though it was, indicated that a general downward adjustment was setting in. In response to this change in basic economic conditions, Federal Reserve Bank discount rates were reduced from 3-1/2 to 3 per cent.

Since that time, the use of open market and discount policies has been complementary. Open market operations have provided sufficient reserves to permit member banks not only to repay a substantial portion of their indebtedness to the Reserve Banks, but also to accumulate some addition to reserves available for bank credit expansion. Discount rates were lowered again in mid-January, from 3 to 2-3/4 per cent.

At the end of 1957, stock market credit to customers of brokers and banks for purchasing and carrying listed securities was less than at midyear and back to the level of early 1955. Thus, the need for using the higher level of margin requirements, established in early 1955, to prevent

an excessive expansion of stock market credit had abated. The Board of Governors in mid-January reduced margin requirements for purchasing or carrying listed securities from 70 to 50 per cent.

System actions have contributed to a marked easing in the credit and capital markets. This is illustrated dramatically by the very sharp drop in market rates of interest, the sharpest drop for any comparable period of which I have knowledge. Yields on Treasury 90-day bills dropped nearly two percentage points--from over 3-1/2 to a recent low of 1-1/2 per cent. This adjustment in credit and capital markets is helping to facilitate and cushion other adjustments in the economy as well as to strengthen demands in important areas dependent on credit financing. It is thus, along with other Government programs, helping to set the stage for recovery in activity and employment.

We all share the hope that recession will be moderate and short-lived, but it is not possible to be completely certain about the future course of economic activity. There is a range of views currently held regarding the duration and extent of this recession and of the timing and vigor of the ensuing recovery. In my own view, the underlying strengths of the economy are many. The inflationary trends seem to have halted before creating maladjustments of such severity as to lead to a protracted period of liquidation and structural realignment in the economy. After not too long a period of readjustment, healthy revival should set in, progressing to new records of economic performance and new high levels of national well being. A great deal depends upon the speed with which needed readjustments are made.

We are all, of course, well aware that reasoning by analogy may be misleading and that history does not repeat itself. Nevertheless, it may be noted that the downward movement from the third quarter 1957 peak has been reminiscent in many ways of the declines that occurred in 1948-49 and in 1953-54. In these two postwar recessions, lows in activity were reached in less than a year from the cyclical peak and recovery to new high levels of output, demands, and employment was rapid and substantial. In both recessions, the industrial production decline was limited to about 10 per cent from high to low. With the exception of the catastrophic depression of the early 1930's, the downward phase of every cycle since World War I has been over or virtually over in the course of about a year.

Many basic forces in the present situation are favorable to hopes for recovery. These include:

- (1) Credit and capital market conditions have already responded to relaxed monetary policy and are much easier than they were a few months ago. Other important financial adjustments have already been made or started. Stock yields, for example, have adjusted to a more normal relationship with high grade bond yields. By borrowing from the capital market, moreover, business firms have been repaying bank debt, thus rebuilding the liquidity positions of both financing institutions and business enterprises.
- (2) Consumer incentives to achieve still higher standards of living are strong, and research continues to

provide new products of wide consumer appeal. As a group, businessmen and consumers continue to have confidence in the long-term growth prospects for our economy. Total retail sales advanced both in December and January and were at levels well above those a year earlier despite lower sales of new automobiles.

- (3) Population increase has been maintained at a rapid pace--the rise of 1.8 per cent in 1957 compares with a postwar average of 1.7 per cent, and hence the market is expanding steadily.
- (4) Consumer incomes have shown some cyclical decline recently, but the decline has been small and moderated by unemployment compensation benefits. Consumer demands are supported by a record volume of financial assets, the ownership of which is widely distributed. Growth in such assets was rapid in 1956 and 1957, while growth in consumer instalment and mortgage debt, though not small, was at a much slower rate than in 1955. The availability and terms of mortgage credit have recently become more favorable to borrowers. New housing starts increased in January and were moderately above their low in the spring of 1957.
- (5) At the State and local government level, community demands for schools and teachers, for roads, public buildings, and other community facilities are

continuing large and insistent. Bond issues of State and local government authorities have advanced to record levels.

- (6) For the Federal Government, postwar budgets have been dominated by the need to cope with critical international stresses and tensions and to provide adequate defense under conditions of major scientific advance and rapid technological change. National security and related problems continue to be urgent.
- (7) Insofar as international economic developments are concerned, Western Europe still shows strength. Industrial activity, while no longer expanding, has generally been maintained at or close to record levels. In general, balance of payments positions have improved although in several countries reserves of gold and foreign exchange are not as large as might be desired. Outside Europe, however, raw materials producing countries are facing difficulties because of declines in volume and prices of their exports.

A primary uncertainty with respect to the timing of economic revival and renewed growth relates to the course of business outlays for new plant and equipment. Some observers view the business capital goods boom of the past three years as having provided a margin of industrial capacity over prospective demands greater than can be absorbed quickly. These observers tend to expect a more protracted period of adjustment than took place in the two preceding cycles.

This concern may turn out to have been well founded, but it may be noted that capacity never appears more excessive than in the midst of receding activity. Recovery, in due course, can certainly be expected to be accompanied by effective and profitable use of the economy's capacity to produce and by still further additions to capacity. The important factors working to expand business capital investment in the period ahead should not be minimized. The advance in the technology of production, in part the result of the huge investment in research of recent years, has been rapid and can be expected to continue. Incentives to reduce costs, to meet competition, and to sustain or improve profitability, are strong.

History shows that our market economy has cyclical characteristics, and the consequences of this irregularity in terms of hardship and unemployment are of deep concern to everyone. When downward readjustment becomes unavoidable, it is incumbent on business enterprises, financial institutions, and labor organizations, as well as Government generally, to adjust policies and programs to foster recovery. We have been concerned, for example, at the decline in output and employment while prices generally have been maintained and some prices even have risen further. Currently, it may be noted, consumer prices reached a new high in November and remained at about that high in December and January. How soon recession is checked and recovery is resumed will be influenced by the rapidity with which economic corrections and adaptations are made in factors beyond the province of monetary policy, that is to say, in business pricing policies, selling practices and productive efficiency; in wage bargaining; in various

financing arrangements; and in the incentives to consumers to buy. In the past, price reductions during periods of contraction served to stimulate increased buying and output and thus to contribute to general recovery and expansion. Undoubtedly, lower prices now would prove to have expansive benefits for economic activity generally.

If needed adjustments are promptly made, the current recession may be moderate and short-lived. Furthermore, there will be the possibility that revival may develop without renewed inflationary tendencies. Under such circumstances, the task of monetary policy would be to foster such revival and to encourage the resumption of orderly growth.

If revival in over-all economic activity becomes exuberant, however, there will be an accompanying danger of resurgence of inflationary pressures. Postwar experience has demonstrated that, in a period of expanding demand, upward pressures on prices and costs can develop quickly. Once under way, inflationary movements tend to spread themselves throughout the economy, not only because of normal market reactions, but also because of a variety of institutional arrangements.

When contractive tendencies in economic activity set in, there is always the hazard that recession may be deeper and more protracted than many anticipate, with a greater degree of underutilization of manpower and industrial resources and with manifest deflationary tendencies. In such an eventuality, further monetary action would need to be considered, both to increase the liquidity of the economy and to encourage expansion of spending financed by credit. Monetary policy by itself, however, cannot assure resumption of high-level employment and sustainable economic growth, although ready availability of credit at reasonable cost is an essential ingredient for recovery.

Those charged with responsibility for national economic policies must at all times reckon with the dangers both of inflation and of deflation. The central policy problem, in one sense, is to prevent either inflationary trends or deflationary trends from becoming dominant. Public policies for one objective or another can have effects that go far beyond those that are intended. Both fiscal and monetary policies must be carefully formulated to exert enough pressure or ease but not too much. That is a difficult task. It is one that you and I both must live with every day, and do the very best we can to reach the judgments and come to the decisions which in the long run will prove to have been wise.

As I have said on many occasions, anti-inflationary policies and anti-deflationary policies are inseparably linked. Excesses on the upside must be avoided in order to avoid the heavy costs and personal hardships that unfortunately develop during the ensuing contraction. Now that we are in the contractive phase, we must take whatever actions are needed to minimize the hardships and to foster vigorous recovery. But in so doing we also must recognize that excessive stimulus during recession can sow seeds of inflation that can grow to jeopardize our long-run stability and our economic strength at a time when as a nation we are confronted with a special urgency to maintain all the productive strength we can muster on a sustainable basis.