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"THE FEDERAL RESERVE SYSTEM IN A TURBULENT WORLD"

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(Following is the complete text of an address to be given by Mr. Hickman on Thursday afternoon, March 7, 1968, at a luncheon in connection with the Fifth Annual College-Business Symposiums sponsored by the Kentucky Chamber of Commerce in cooperation with the Chambers of Commerce in Owensboro, Louisville and Lexington.)

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These are turbulent and troublesome times for the country and its central bank -- the Federal Reserve -- and in times of turmoil it is always difficult to disentangle the transient day-to-day events, from the underlying basic fabric of developments.

If any of you have been so preoccupied with your business duties that you are unaware of this turbulence, let me refresh your memories by reading a few headlines that appeared in the New York Times over the past several months. On August 4, 1967, a headline in the Times said: "Johnson asks for 10% surcharge on personal and business taxes"; on October 4 the headline read: "House unit votes to delay action on tax surcharge"; on November 19 it read: "British devalue pound to \$2.40 to avert a new economic crisis"; on November 20 the headline read: "Federal Reserve rate up"; on November 21: "Prime bank rate begins to go up"; on December 16: "House unit to restudy tax rise when it reconvenes next month"; on the 17th the headline said: "U. S. and 6 nations vow to keep gold at \$35 an ounce"; on December 28:

"Federal Reserve curtails money banks may lend"; on January 2, 1968: "Johnson acts on dollar: curbs investing abroad and asks cut in tourism"; on January 18, the New York Times headline stated: "Johnson's budget \$186-billion; he wants gold reserve freed"; and finally on February 2, "President asks pay-price curbs and rise in tax... Economic Report says failure to act risks a 'feverish boom'."

These headlines, or the facts on which they are based, are the regular diet of the Federal Open Market Committee, on which I became a voting member on March 1, (This committee is composed of the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, the presidents of the Federal Reserve Banks of Chicago and Cleveland, who alternate every other year, and three other presidents, who serve on a rotating basis every third year.) The FOMC meets in Washington every three or four weeks and is the principal policy-making body of the U. S. monetary authority.

For example, when President Johnson proposed in August a surtax of 10%, rather than an earlier request for 7%, he did so on the recommendation of Secretary Fowler and with the complete endorsement of Chairman Martin and the FOMC. At that time, the economy was beginning to overheat, yet the FOMC did not act to restrict the growth of money and credit, partly because of the large war-related deficit, which had to be financed by the Treasury, and partly because of the expectation that Congress and the Administration would act on taxes and spending.

The decision of the Mills Committee to postpone action on the surtax, as reported in the Times on October 4, was a keen disappointment to all of us; but again we did not act to tighten credit, partly because a Treasury financing was scheduled at that time, and partly because of our concern over the weak position of the British pound. Tighter credit conditions in the U. S. might well have pulled funds out of London through the Eurodollar market into U. S. banks, thus intensifying Britain's difficulties.

The devaluation of the pound reported by the Times on Sunday, November 19, was something that the System had been trying to avoid for several years through our swap network and through direct extensions of credit to the Bank of England by the International Monetary Fund, the Treasury, the Federal Reserve, and other central banks. We were advised at a meeting of the FOMC in Washington on Tuesday preceding the devaluation that the pound was in serious trouble, unless massive credits could be negotiated promptly for Great Britain (indeed, the FOMC voted special stand-by credits to the Bank of England at that meeting), but these negotiations were unsatisfactory from the British point of view, and the Reserve Bank presidents were advised by telephone early Saturday that the British had decided to devalue the pound.

Early in the morning of the next day, Sunday, November 19, our directors were contacted and a telephone conference was scheduled for 10:30 a.m. At that meeting we decided to raise our discount rate by one-half percent from 4% to 4 1/2%, subject to approval by the Board of Governors. Similar action was taken at most of the other Reserve Banks and the discount rate increases were approved in a special session of the Board of Governors and announced Sunday afternoon. This step was intended to serve as a symbol to the world that the Federal Reserve System is determined to defend the value of the dollar at all costs, and I think was generally interpreted correctly and had the desired effect. I might say that I was one who believed that the situation was so grave as to warrant a larger increase, of say, 1%, but some of the other banks and the Board of Governors did not go along with that; and since I wanted Cleveland to be included with the majority in the first announcement, I recommended to my board of directors an increase of one-half percent. As you know, many commercial banks raised their prime rates from 5 1/2% to 6% on Monday, November 20; this fact was reported as a fait accompli in the Times on Tuesday, November 21.

Despite the rise in the discount rate, the devaluation of the pound triggered a wave of speculation against the dollar, and caused a sharp increase in speculative buying in the London gold market, which is supported by the London Gold Pool, to which the U. S. supplies nearly 60% of the gold. Speculation soon reached epidemic proportions despite the fact that the Federal Reserve System, with the cooperation of the Bank for International Settlements and various central banks, was operating to support the dollar through its swap network and through intervention in the spot and forward markets for key foreign currencies. It was, therefore, decided that some further "announcement effect" was needed, and this was forthcoming on Saturday, December 16, when Secretary Fowler and Chairman Martin, speaking for the U. S., and representatives for six other countries announced simultaneously their determination to cooperate to hold the gold price at \$35 per ounce. (Again, the Reserve Bank presidents were consulted by telephone on these developments.) Almost immediately the announcement had the desired effect on the gold market, and on the dollar, which strengthened in terms of most European currencies. Speculation against the dollar and the run on gold also caused the Mills Committee to reopen its study of the proposed surtax increase, although Congress subsequently adjourned for the year without acting on taxes.

When it became evident that Congress would adjourn without acting on the President's tax proposal, the FOMC voted eleven to one to make a modest move towards less ease at its meeting on December 12 (which decision, incidentally, was kept under wraps and did not make the headlines); however, at 4 p.m. on Wednesday, December 27, the Federal Reserve Board (following discussions as to the strategy of such a step at the preceding FOMC meeting) made the move public by announcing an increase in reserve requirements of one-half percent, effective January 11 for city banks and

January 18 for country banks, for demand deposits in excess of \$5 million. This action absorbed about \$550 million of reserves during January. Since we expected to absorb a somewhat smaller amount of redundant reserves in January by selling securities into the market, this action had the effect of switching us from the seller's to the buyer's side of the market, a desirable technical maneuver in view of the extreme weakness in the securities markets at that time.

The announcement on January 1 that the President had decided to act to curb foreign investment and to cut tourism was caused initially by the very poor balance of payments figures for the fourth quarter, and the very heavy gold losses after the devaluation of the pound sterling. This was a matter that the FOMC had been discussing for some time and various contingency plans had been drafted in the event that further steps were needed. In fact, when I first heard about the fourth quarter deficit, I must confess that I felt that immediate steps should be taken to curb foreign investment and tourism temporarily, to give us time to get our domestic house in order. The Reserve Bank presidents were again immediately informed, and a nationwide telephone conference was held on New Year's Day to discuss the ramifications and the implementation of the financial institution portion of the President's program assigned to the Federal Reserve System. The balance of payments deficit, incidentally, had been running at about a \$2 billion annual rate for the first three quarters of 1967 and suddenly jumped in the fourth quarter to an estimated annual rate of \$7.3 billion.

In President Johnson's State of the Union message, the size of the budget, the budget deficit, the new unified budget concept, and the President's request that the gold reserve be freed to provide gold to support the dollar, are all matters that closely relate to Federal Reserve attitudes and policy in various ways. The gold reserve refers to the mandatory 25% ratio required to be held at each of the 12 Federal Reserve

Banks against its note obligations. Twelve years ago there were \$3 in gold for every \$4 of Federal Reserve Notes outstanding and the ratio now is about \$1 to \$4 (the magic 25% figure mentioned in the President's State of the Union message). We now have to adjust the gold reserves among the 12 banks almost daily, and with any material further shrinkage in the gold stock, we could no longer meet the statutory requirements.

The new unified budget concept unveiled by the President in the State of the Union message was something that had been pushed by some of us for several years, when it became apparent that the various budgets then in use were confusing the people, the Congress, the Administration, and at least one member of the FOMC. Finally, the \$186 billion aggregate spending figure mentioned by the President, on the new budget basis, represents an increase of only \$3 billion for Vietnam, plus \$7 billion already voted by the Congress. These figures were subsequently confirmed in the budget document for fiscal year 1969, which was released on January 29. The story was reported in the New York Times of January 30, under the headline "Record 186-billion budget is presented by Johnson; tax rise required, he says." While further small cutbacks in Federal expenditures are doubtless possible, I personally am convinced that the budgeted increase is nearly minimal. Spending for Great Society purposes would have been much larger if it had not been for our weak balance of payments position, the Administration's efforts to obtain a tax increase, and the additional consideration that if expenditures were not restricted, and taxes were not raised, the Federal Reserve would undoubtedly feel compelled to allow credit to tighten further, with all the real and imaginary stresses and strains that would result from that action.

There have been other newspaper headlines and reports on day-to-day developments following the ones I have reviewed today. But they still represent variations on a common theme and all reflect two fundamental problems. The basic problems are: (1) the continuing deficit in the Federal budget, and (2) the continuing deficit in our balance of payments. In the last twelve years, covering one Republican and two Democratic administrations, we have had a surplus in the Federal administrative and cash budget only three times, and a deficit aggregating about \$40 to \$50 billion for the full period, depending on the definition. Correspondingly, we have had a balance of payments deficit in all but one year, amounting in the aggregate to \$28 billion, and a gold loss of \$10 billion.

These two problems are, in fact, so closely interrelated as to reduce to only one basic problem. When the Federal government runs a deficit it spends more than it takes in, so that the government sector is expansionary. I believe that expansionary government spending is desirable when there are unutilized pools of resources in the economy, but undesirable when these pools are exhausted so that aggregate demand exceeds the nation's capacity to produce. When that occurs several things begin to happen simultaneously. The Federal deficit must be financed through the banking system, which causes an inflationary expansion of bank credit and the money supply. Part of the rising income of individuals, businesses, and government is spent on goods and services produced domestically, which causes domestic prices to rise. An additional portion of the increase in income is spent on goods and services produced abroad (that is, on tourism, direct foreign investment, indirect foreign investment, foreign aid, and so forth). Finally, if prices rise faster at home than abroad, U. S. exports become less competitive and foreign imports become more attractive, so that our trade balance (which, thus far, has been a major factor of strength in our

balance of payments) begins to fall. In fact, the sharp decline in our trade balance, along with the conversion into dollars of Britain's portfolio of U. S. securities, were major factors contributing to the sharp deterioration in our balance of payments in the fourth quarter of 1967.

All of this is simply another way of saying that we now have an inflationary economy. As most of you are well aware, this country has been enjoying the longest business expansion on record (seven years last month, since the last business cycle trough in February 1961), and hopefully the expansion can continue indefinitely without a costly business contraction such as those that plagued the U. S. economy in years gone by. A basic objective of the Federal Reserve, in fact, is to avoid just such a contraction. More generally, we seek to promote sustainable economic growth, without price inflation, and with equilibrium in our balance of payments. As the record of the past few years has clearly shown, monetary policy alone cannot achieve those objectives, although it can help. To achieve them, we need a proper mix of monetary and fiscal policy, or as some would say, more fiscal policy and less monetary policy.

We were fortunate enough to have a reasonable mix of monetary and fiscal policy over most of the period, 1961-65, and the economy progressed at a sustainable rate, with only a small upward tilt in the price level. In mid-1965, however, the Administration made what I now consider (with 20-20 hindsight) to have been a major economic miscalculation, perhaps because of a somewhat clearer comprehension of the "old politics" than of the "new economics." For whatever reason, at a time when the economy was at virtually full employment, the Administration attempted to escalate the war in Vietnam and to continue Great Society programs, and to try to finance both things together through a larger deficit, rather than by appealing frankly

and openly to the American people for higher taxes. As the deficit burgeoned, the economy overheated, and prices rose, the Federal Reserve began a series of steps to tighten credit, which, of course, culminated in the Great Credit Crunch of 1966. The economy then leveled off, and would have turned down, if it had not been for a sharp reversal of monetary policy by the Federal Reserve. My feeling now (again with the advantage of 20-20 hindsight) is that we probably overplayed our hand a bit on the side of ease in 1967, but the evidence is by no means one-sided on that; we had to provide credit to the Treasury to finance the war effort, and we also did not want to make a premature move towards tight money while there was still a chance of a tax increase. In any event, it is now clear to most of us that we are again faced with an overheated economy.

As I have said, the type of stop-go performance that we have had in the last two and a half years has been caused by the fact that we have had to rely too much on monetary policy and not enough on fiscal policy. Unless we are willing to settle for a slack economy, with unacceptably high unemployment rates and low capacity utilization rates, and to give up basic domestic and foreign policy goals that have been strongly endorsed by most of the American people, we must find some way of adjusting our fiscal policy more flexibly. The long drawn out struggle between the Administration and the Mills Committee convinces me that the present arrangements are simply not good enough for a modern full-employment economy. Over part of the postwar period Great Britain had economic stagnation, then an overheated stop-go economy, and finally crisis and devaluation. The U. S. now has stop-go, and we must take steps promptly if we are to avoid similar types of distortions and dislocations. In the final analysis, the commerce of the whole Free World depends on the strength and convertibility of the dollar, i. e., on our ability and willingness to sell gold at a fixed price of \$35 per ounce.

The Federal Reserve has already taken a modest step toward less monetary ease. The next step should be fiscal. If you believe as I do that the President's budget is minimal (in view of Vietnam requirements and the pressing welfare problems in our cities), then the only logical route is through higher taxes. Very little more can be saved through further efforts to pare spending. Of course, all of our major problems would be solved (the deficits in the Federal budget and in the balance of payments) if an acceptable solution could be found for the Vietnam problem, and if thereafter we acted with reasonable prudence on both the domestic and international fronts. We can all work and hope and pray for an early solution in Vietnam. But in the meantime, I think higher taxes are urgently needed to cool off the domestic economy and to reduce the deficit in our balance of payments. I might add that I personally think higher taxes are highly desirable on moral grounds, as well as for economic reasons. When some are giving their lives for their country, those of us not directly involved should at least be willing to make a modest fiscal contribution.

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