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Tax Review

Monetary Policy in 1961

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IN OUR COUNTRY, the government cannot force anyone to lend his money at rates he is unwilling to accept—any more than it can force him to spend his money at prices he is unwilling to pay. In the securities market, investors always have the alternative of investing their funds in short-term securities if they feel that yields in the longer-term area are unfavorable.

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

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

I do not believe anyone expects the Federal Reserve to engage in operations that will promote a resurgence of inflation in the future. In combating inflation in the past, undue reliance has perhaps been placed on monetary policy. I can readily agree with those who would have fiscal policy, with all of its powerful force, carry a greater responsibility for combating inflation, and I am encouraged to think that this may be likely in the future. If we do this, we should more nearly achieve our over-all stabilization goals, along with some reduction in the range of interest rate fluctuation.

That, however, is a matter for another day. Today, we have in this country a serious problem to contend with in the erratic but persistent rise

This Issue In Brief

The Federal Reserve System has taken important steps to ease the current recession, notes Mr. Martin in this *Review*. But the recession poses peculiar problems. One is the necessity of checking the balance of payments deficit and the outflow of gold. He stresses that easy credit conditions could well lead to further outflow. This situation has led to an experiment in open market operations, designed to "nudge" long-term rates lower while taking steps to prevent outflow of short-term capital.

Mr. Martin surveys the recession's concentration on particular areas and industries and the relatively large amount of "structural" unemployment. He shows the difficulties of dealing with this kind of unemployment through general monetary and fiscal policy, and suggests some appropriate remedies.

in unemployment that has taken place since mid-1960. In January, the seasonally adjusted rate of unemployment was 6.6 per cent of the labor force, the highest percentage since 1958; the actual number of persons unemployed was 5.4 million, the highest number since the days before World War II.

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

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

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

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

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

William McC. Martin, Jr., was first appointed a member of and designated Chairman, Board of Governors of the Federal Reserve System in 1951. He was redesignated Chairman (for 4 years) in April, 1955 and March, 1959. He served as President of the New York Stock Exchange from 1938 to 1941. He was Assistant Secretary of the Treasury from 1949 to 1951. This *Review* is based on a statement Mr. Martin made before the Joint Economic Committee earlier this month.

Analysis of current unemployment shows that, in brief:

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

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

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

Leadership Rather Than Action

Actions best suited to helping these groups would appear to include more training and re-training to develop skills needed in expanding industries; provision of more and better information about job opportunities for various skills in various local labor markets; tax programs to stimulate investment that will expand work opportunities; revision of pension and benefit plans to eliminate penalties on employees moving to new jobs; reduction of impediments to entry into jobs, and so on. Measures to alleviate distress and hardship are, of course, imperative at all times.

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

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

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

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

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

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

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

The most significant thing about the Federal Reserve's operations in 1960 is not that they were extraordinary but, instead, that they were typical of Federal Reserve operations under the flexible monetary policy that has been in effect now for a full decade.

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

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

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

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

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

Decline Presented Dilemma

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

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

If, on the other hand, the Federal Reserve refrained from further action to supply funds for bank reserves because of the balance-of-payments situation, it would be unable to make its maximum contribution toward counteracting decline in domestic economic activity through the stimulative influence of credit ease.

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

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

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

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

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

Must Remain Alert and Ready

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

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

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

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

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

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

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

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

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

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

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