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Statement of Wm. McC. Martin, Jr., Chairman,
Board of Governors of the Federal Reserve System,
before the
Senate Banking and Currency Committee.

2:30 p. m. March 4, 1952.

Gentlemen:

You have asked me to testify this afternoon on the over-all state of the economy rather than on those sections of the Defense Production Act with which the Federal Reserve System is directly concerned. The views of the Board of Governors with respect to the Act will be submitted to the Committee in a separate memorandum. Accordingly, I shall undertake to present my personal views on the economic and financial problems facing the country. I shall leave with you a memorandum on the economic situation prepared by the Board's staff.

For a full year there has been abatement of the surging inflationary pressures that developed after the outbreak of hostilities in Korea. During that year the annual rate of expenditures on this program has risen by about 20 billion dollars. The expansion of outlays on private accounts to enlarge our defense supporting industrial base is also well advanced. This record is impressive.

The abatement of inflationary forces has reflected a variety of developments in the economy generally, including the application of restraints. They are dealt with in more detail in the memorandum prepared by the Board's staff. We feel that the Federal Reserve has played a part in the salutary result, not the principal part, but an indispensable part. In the period ahead defense spending will rise to its peak, with major impact on the economy. I will not attempt to forecast what the consequences of that

impact will be. It is clear, however, that the present is not a time to dispense with the tools that are necessary for the restraint of inflation.

I do not think anyone can confidently forecast the period ahead or the repercussions on the economy of the defense program on which we have embarked. The forces involved are complex. Who at this time last year thought that inflationary pressures were at a peak, at least temporarily, and that the year ahead would be characterized by the relative stability that was, in fact, achieved? This experience well illustrates the hazards of forecasting. The most we can do in surveying the future is to lay out the nature of the problems that may be presented and prepare ourselves to deal with them as competently as we can.

Large as it is, our defense program is within our physical capacity as a nation. We have available the manpower, the equipment, the raw materials and the know-how, to carry the program and to maintain a high standard of living. Such misgivings as I have relate more to the financial than to the physical problem. Our taxes are already heavy, yet they are not sufficient to cover total Federal expenditures. During the last half of this calendar year we will face the problem of financing a large and growing Federal deficit. We all know that if the deficit is financed by borrowing from the banking system such borrowing will increase the volume of bank deposits and thus inflate further the money supply. Our major problem will be to find ways and means of financing the deficit by borrowing individual, institutional and corporate savings. The savings are there. If

saving continues in its present volume, this can be done. The program will be within our financial as well as our physical capacity.

During the past year the American people have saved at unusually high rates. Otherwise, inflationary pressures would have been great. The task ahead is to do everything possible to encourage continued high savings and their investment in Government securities. In this way the deficit that looms can be financed without resort to the inflationary process of creating additional supplies of bank credit. This view of the problem is fully shared by the Treasury. We see eye to eye on this problem and are cooperating together to develop an effective program to deal with it.

You have before you the official forecasts of the deficit as contained in the President's budget message. That was prepared some time ago and it may be that the deficit will turn out to be materially lower than the official forecast, due to a slower rate of spending by the defense agencies. On the other hand, the outlays for military equipment may mount rapidly as bottlenecks are cleared away, sufficiently rapidly to catch up with the rate of spending assumed in the budget estimates. I think the essential nature of the problem at hand remains the same regardless of which view may turn out to be more nearly right. The blunt fact is that even if the more moderate estimates should be realized and expenditures are less than the estimates, we still face a deficit financing problem that can create serious inflationary pressures if the deficit were financed through the banking system. The most optimistic estimates of our budgetary position still leave the Government with

a financing problem of large magnitude. Every increase in the deficit increases that problem. Moreover, we do not know what will happen internationally. There is a tendency just now to think that the immediate danger abroad is less. While we all hope that the danger is in fact less, we cannot run the risk of relying on that hope.

You will probably hear from some observers who feel that the danger of a further resurgence of inflation is past or nearly past. They are impressed by the many soft spots in the economy and by the slide of sensitive prices during recent weeks. It is true that there are soft spots in the economy and that some prices are weak. These reflect situations such as Detroit where cutbacks in the use of essential materials have resulted in cutbacks in employment. Soft spots of this type do not mean that inflationary pressures are over. The defense agencies are moving rapidly to place contracts in these areas, and there will be a gradual lifting of restrictions on civilian output as supplies of materials become available.

Some soft spots in the economy today, such as in the textile industry, reflect excessive buying in the period immediately following Korea rather than the effect of cutbacks in the use of essential materials. For about eight months following Korea, consumers and businessmen were on a buying spree. They thought that a full war economy was in the making and that all sorts of commodities would be scarce. They thought that prices could only go up. It was a period of reckless spending and borrowing. It has left a lot of headaches, especially among businesses that borrowed too

much to acquire inventories at prices that are now demonstrated to have been too high; headaches in expansion plans that proved too large to carry out efficiently; headaches in the form of large holdings of receivables and of inventories of finished products when customer markets turned sluggish.

It is fortunate that this situation was not even worse. You cannot have a period of reckless private spending such as occurred in this country immediately after Korea without an aftermath.

Now I don't know how long it will take to get over these headaches. I do feel, however, that it would be a great mistake to think that because of them we should be complacent about the deficit on the theory that just a little touch of further inflation would do no harm. The prospective deficit and the continued "take" required for defense are too large to take that risk. Furthermore, the international situation is too tense. This program is going to cost a lot of money for a long time. We must carry it out without further inflation. Neither this country nor the world can afford to lose confidence in the dollar.

I wonder if we fully appreciate the significance of the dollar and what it stands for in the world today. For several years I was immersed in our foreign financial dealings at the Treasury and I learned at first hand, day by day, what the dollar really means in a world of currencies that are in many cases all too weak. The dollar holds a pivotal position in the financial reconstruction of the free world today. It signifies far more than the material and military might of the United States. It symbolizes the moral strength of the American people and their determination to preserve its integrity.