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Statement of

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

February 5, 1957

On behalf of the Board of Governors I wish to say again that we are always glad to have an opportunity to appear here. We welcome inquiry into what monetary and credit policy can do, and cannot do, to aid in achieving the goal of sustained economic growth and widespread prosperity.

The national economy continues to operate at the highest levels in history. Gross national product reached the unprecedented rate of \$424 billion by the last quarter of 1956. National income reached more than \$352 billion, personal incomes more than \$333 billion, and civilian employment about 65,000,000. These figures mark new highs.

The year 1956 opened with the economy generally operating at near capacity levels. A sharp rise in business expenditures for new plant and equipment, combined with increased spending by consumers and by State and local governments, more than offset decreased spending for automobiles and new home construction, thus imposing further heavy demands upon productive resources. Wage rates as well as prices for goods and services moved upward. The year ended as it began, with the economic climate dominated by inflationary pressures.

In this environment of intensive utilization of national resources, the aim of monetary policy has been to restrain inflationary tendencies, while providing at the same time for orderly economic growth. Over the year, the Federal Reserve System sought to prevent too rapid expansion of bank credit and the money supply by restricting the availability of bank reserves. To have permitted more rapid expansion of bank credit and the money supply would have intensified inflationary pressures already present in the economy. It would not have produced more goods. Rather, it would have increased prices further. Without relative stability of the currency, continued high utilization of resources would have been in jeopardy.

Commercial bank loans and investments in the aggregate rose only moderately during 1956. Banks expanded their loans substantially but to a large extent they obtained the necessary funds by reducing their investments in Government securities. As a result, while there was little further growth in the supply of money, there was a more active use of existing money, as indicated by an 8 per cent rise in demand deposit turnover.

The great bulk of all loanable funds is provided by savings of businesses and individuals. Although the volume of savings was somewhat higher in 1956 than in 1955, the growth was not enough to keep pace with the rapidly increasing demands. Interest rates on borrowed funds rose sharply over the year, particularly on long-term borrowing.

Interest rate changes, as well as other price movements, reflect supply-demand relationships. Rising rates, like rises in other prices, indicate that demand is exceeding supply. They discourage some borrowing on the one hand and encourage increased saving on the other. Thus they perform the vital function of balancing supply and demand. Current interest rates are a signal that the economy is straining its resources by trying to accomplish more at one time than resources permit.

Economic realities cannot be eliminated or circumvented by government fiat. Even the Congress with its enormous powers to redirect the available resources of the country must operate within the aggregate of resources available. In other words, under conditions of heavy utilization of resources generally, an increase in the resources made available to any one sector of the community would have to be taken from other sectors either by taxation, or by some form of direct rationing, or by the processes of the market. They cannot be made available by attempts to ease credit. That is the road to inflation. In 1956, fully half of the increase in gross national product represented a mark-up in prices. Had commercial banks been enabled to generate sufficient new money to satisfy all the demands for funds that were pressing on the market, the result perhaps would have been a smaller rise in interest rates, but at the expense of a sharper rise in prices of goods and services.

In the final analysis, investment must be financed out of saving from current income. This economic principle cannot be vitiated by any form of monetary manipulation. * Under our institutions there is no practicable way of balancing savings and investment without flexible interest rates.

Monetary policy must be administered with regard to changing situations in the financial markets. During 1956, within its general policy of restraint, System operations met seasonal changes in the reserve needs of member banks and also cushioned disturbing movements in financial markets, including those arising from necessary Treasury financing. From time to time, during the course of the year, the degree of restraint was adjusted to variations in the financial climate and in business activity.

Notwithstanding the combined influence of restraint on credit expansion and the realization of a substantial cash surplus in the Federal budget, prices of goods and services moved upward in 1956. Increases of 4-1/2 per cent in wholesale prices and 3 per cent in the consumer price index are indicative of the vigor of demands. Such increases cannot be accepted complacently.

In a growing, competitive economy such as ours, production and prices for individual commodities fluctuate over a considerable range in response to changes in supply and demand without creating serious over-all instability. These adjustments are necessary

to economic progress. They are part of the process of developing and maintaining high level employment, economic growth, free markets, and over-all stability in the price level. Even though many components may be unstable, the total economy can still experience an upward trend in production and employment with a horizontal trend in average prices.

In recent years, large shifts in the flow of funds through the economy have originated in such important areas as the Federal budget, agriculture, business investment, consumer outlays for durable goods and housing, and State and local governments. Declines in some sectors have released resources that have made possible increases in others. Such rolling adjustments not only are inescapable in a dynamic and unregimented economy, but the ability to adjust to changes with resiliency and flexibility, and with a minimum of government interference, is one of the great virtues of a private enterprise system.

We know from experience, however, that the pathway of economic growth cannot be free of turns and dips. Experience tells us that important shifts in demands in major economic sectors can be so powerful as to have an excessively stimulative or depressive impact on the whole economy. Where the effects of such shifts become cumulative, they can develop into serious booms and depressions.

Monetary and credit measures, by being adapted promptly to shifts in

total demand relative to the supply of available resources, play an essential role in moderating these cumulative forces and in promoting orderly growth and financial stability.

Considerable attention has been focused of late on the impact of monetary and credit policy on various sectors of the economy. Higher interest rates as a mechanism for allocating the available supply of funds among different credit seekers have been sharply criticized. It is frequently contended that monetary policy is depriving communities of such vital needs as schools, housing, and roads. Similarly, small business is said to be injured.

These are debatable matters to say the least. School and road construction, home building, and small business activity are actually at high levels. In some of these sectors, many borrowers have been prevented from competing in the market for savings by statutory or regulatory limitations on the maximum interest rates they are allowed to pay. As a result, borrowers thus affected have borne a disproportionate brunt of general credit restraint. The cause of this disproportion, however, lies in the interest rate limitations that have kept some borrowers out of the market and not in the effort to restrain inflation. All of these sectors would suffer infinitely more from further inflationary bites out of the purchasing power of the dollar than they would from temporarily foregoing some of their borrowing--however worthy the purpose--if their plans and programs cannot be financed out of saving or, in the case of schools and roads, for example, out of taxes.

It is important to recognize that the problem of monetary stability is to keep the use of credit in line with resources available of goods for production/and services. To accomplish this, some demands must temporarily go unsatisfied. Naturally, these deferments are of great concern to all of us, but unlimited supplies of easy money would only complicate and worsen the situation.

It has been suggested that the Government should take action to enable certain meritorious programs to move forward relatively unhampered by the effects of monetary restraint. These proposals present very difficult questions of public policy, which can be decided only by the Congress. Programs designed to make funds more readily available to some users should be accompanied by action reducing still further their availability to others, for example, in some cases, by increased taxation. Otherwise, the effect will be to intensify inflationary pressures and imperil price and monetary stability.

The problem is not insoluble. The correction of economic imbalances takes times, but corrective forces have been and still are operating. Our nation unquestionably has the resources to provide for a continuously rising level of physical well-being, educational attainment, and cultural development. Our resources are steadily growing and so is our ability to use them intelligently. What cannot be accomplished today may become readily attainable in the not too distant future.

Supplemental Questions Addressed to the Chairman of the
Board of Governors of the Federal Reserve System

Joint Economic Committee
Hearings, February 5, 1957

1. "What information do you have about the impact of so-called general credit controls upon small business as compared with big business? Upon State and local governments as compared with nongovernmental credit users?"

Manifestly, the effects of credit restraint are felt by more small businesses, numerically, than by large ones. This does not necessarily mean that the impact of general credit restraints falls disproportionately on small businesses. There are over 4-1/4 million business enterprises in this country. Most of these would be considered small business under any standard of measurement, and only about one in a thousand would be classed as big business.

The major difference between small and large business is not in their direct access to some source of credit but, rather, in their access to alternate sources of credit. Unlike most small businesses, most large businesses generally have direct contact with and access to a number of banks as well as to other sources of outside financing. Consequently, at a time when overall credit demands are greater than can be fully met without inflationary impact, a larger number of small businesses than large ones find it difficult to secure their customary credit accommodation.

The Federal Reserve System cannot allocate credit among groups of borrowers. With demands for goods and services exceeding capacity to produce, monetary policy over the past year has been directed toward keeping expansion of the total credit supply within limits set by the willingness of the community to save. The market place has determined the allocation of the available supply of savings.

With aggregate demands for materials and credit so large, it is obvious that available productive capacity and savings could not accommodate all credit-worthy applicants to the full extent of their desires. All of us know of legitimate, useful projects that have had to be deferred or reduced in scale, because either the physical or financial resources could not be obtained.

We know of no figures that permit a precise measure of the relative impact of credit restraints, in particular, on different groups of borrowers. We have, however, assembled a considerable body of information that may help to illuminate this troublesome question.

A survey of business loans made in October 1955 shows that one-fifth of the total dollar volume of the business loans held on that date were loans to firms with assets of less than \$250,000, and more than one-third were loans to firms with assets of less than \$1 million. Most commercial banks are small enterprises themselves; nearly 85 per cent of our 14,000 commercial banks have deposits of under \$10 million, and, necessarily, most of the lending of these smaller banks is to small businesses. In October 1955, over nine-tenths of the number and four-fifths of the dollar volume of business loans held by small banks were loans to firms with assets of less than \$250,000, and these loans accounted for about one-fifth of the dollar volume of all commercial bank loans to such small businesses. With the close and direct contact with customers that smaller banks enjoy, and with so large a stake in the financial position of their small customers, it is evident that most commercial banks have a strong incentive to maintain the volume of bank credit flowing to smaller businesses.

Even at large banks, lending to small business represents a significant share of their loan volume. In October 1955, banks with deposits of \$100 million or more accounted for about two-fifths of all bank loans to small business. At these larger banks, small business loans represented three-quarters of the number and one-tenth of the dollar volume of their business loan portfolios. Lending to small firms is profitable business, and most large banks are anxious to obtain this type of business.

Information on the structure of bank loans to business since late 1955 is less comprehensive. We do receive reports from large banks in major financial centers on the size distribution of new business loans of over \$1,000 made in a two-week period of each quarter. These figures indicate that from mid-1955 to mid-1956 the number and dollar volume of all new business loans made increased to record levels. Increases were recorded in all loan-size categories, with the sharpest rise in loans of \$200,000 and over. The average size of new loan made increased about 30 per cent over this period.

The rise in average size of business loan extended by large commercial banks reflected primarily the shift in patterns of industrial demand that occurred last year. When the bulk of the loan demand on commercial banks is from industries where larger business units predominate, such as public utilities, machinery or metals manufacturing, the average size is larger than when most of the loan demand arises primarily from the needs of retail merchants or service industries. This past year has seen such a shift in demands, with the emphasis on borrowing to meet financial needs in industries characterized by large producing units.

From June to December of 1956, the volume of new loans made declined about one-eighth from the peaks reached in June. The decline was of equal proportion in all major size categories, and there was very little change in the average size of loan.

With interest costs rising generally, both large and small borrowers have had to pay more for their loans. Since mid-1955, the average interest paid at large banks on short-term business loans of \$200,000 or more rose by 87 basis points, to 4.20 per cent, while costs on loans of from \$1,000 to \$100,000 went up 60 basis points, to 4.94 per cent.

Loan applications to the Small Business Administration rose from about 3,000 in 1955 to almost 6,000 in 1956. Loan approvals increased more rapidly, rising from 1,448 loans, amounting to about \$55 million in 1955, to 2,890 loans, amounting to about \$122 million. These figures are not large relative to the size of the small business population or to the usual volume of lending to small businesses by commercial banks.

An increasing share of the loan funds supplied by SBA last year was for longer-term purposes, such as purchase of plant and equipment or consolidation of obligations, rather than for working capital. The proportion of loans made by SBA carrying final maturities of less than 3 years was small. Most maturities were longer than were customary in commercial bank business loans.

Reports on manufacturing corporations, compiled quarterly by the Federal Trade Commission, indicate that the return on shareholders' equity and profits per dollar of sales both increased substantially for smaller businesses from the third quarter of 1955 to the third quarter of 1956 (the latest data now available). Over this period, return on equity, after taxes, rose from 10.4 per cent to 15.3 per cent for the smallest companies, as compared with a decline from 12.3 to 11.0 for the total. Profits per dollar of sales rose from 2.2 per cent to 3.0 per cent for the smallest companies, compared with a decline for all manufacturing corporations over the period.

These reports also indicate that the liquidity position of small corporations deteriorated much less last year than that of large companies. The ratio of cash balances and Government security holdings to total current liabilities for the smallest companies declined from 37 per cent to 34 per cent over the period, while for all manufacturing corporations, the decline was from 71 per cent to 55 per cent.

Statistics published by Dun and Bradstreet on business failures indicate that the number of failures where the liability involved was less than \$25,000 rose by one-seventh, as compared with an increase of one-fourth in the number of firms failing with liabilities of \$100,000. The dollar amount of debts involved in failures of small firms also rose less than did the debts of larger firms failing last year.

State and local governments

State and local governments spent about \$10.7 billion last year for construction of schools, highways and other community facilities. This was about 10 per cent more than was spent for these purposes in 1955. Bond issues for new money floated by State and local governments during the year amounted to about \$5.4 billion, about one-tenth less than was floated in 1955. All of the reduction in flotations was in issues to finance toll highway construction and in bond issues to fund the short-term debt incurred for public housing projects. Financing of school construction continued at the record level of the previous year, and financing of sanitation and other community facilities increased sharply.

The decline in toll road financing reflected reconsideration of many highway projects contemplated earlier. The financial difficulties experienced with some recently completed roads (financed for the most part at lower interest costs), rising materials, labor and credit costs, and uncertainties about developments in the new Federal highway program led to the deferral of several projects.

Construction outlays for public housing continued at close to 1955 levels, but an increasing share was financed through short-term debt. Instead of funding the notes issued by local housing authorities on completion of construction, these notes were "rolled-over" and fewer long-term housing bonds were issued in 1956.

Deferral of long-term financing last year reflected the rapid rise in costs of all types of long-term borrowing. Yields on high-grade corporate bonds outstanding rose 63 basis points, and yields on new issues rose almost 100 points. In addition, repayment terms on corporate issues became substantially more restrictive last year, with longer "no-call" provisions and higher call prices required of borrowers.

Yields on high-grade State and local bonds outstanding rose 75 basis points over the year, but these bonds still offered investors returns about three-quarters of a percentage point less than comparable quality corporate securities. This was close to the differential that existed in 1955. For investors subject to high corporate or personal income tax rates, the exemption from Federal income taxation of interest received on State and local government obligations offsets the lower rate of return. This feature is not one of prime importance to investors subject to lower tax rates, however, particularly for institutional investors such as life insurance companies, pension funds and mutual savings banks, which receive a large share of the community's long-term savings. As the volume of State and local long-term borrowing increases beyond the supply of investment funds attracted by the tax-exemption feature, it becomes increasingly necessary for these governments to compete for funds on a straight return basis.

In part, the stability of the differential between yields on corporate and municipal bonds reflects the acumen of the officers managing the finances of State and local governments. Because the planning and financing of large-scale construction projects is usually undertaken long before construction actually begins, finance officers can time the flotation of bonds to take advantage of temporary ebbs and flows of funds into and out of security markets. On several occasions in 1956, the volume of security issues floated was greater than the supply of investment funds could accommodate, and security dealers' inventories of unsold securities increased rapidly. As these situations of temporary congestion developed, finance officers postponed some offerings.

A survey made last year indicated that about 120 issues, aggregating \$175 million, were not sold on previously announced flotation dates during the third quarter of 1956. The Board's staff has followed the subsequent history of these issues; they found that 41 of the issues were sold later in that same quarter and 28 were sold in the fourth quarter of the year. By year-end, three-fifths of the number and two-fifths of the dollar volume of the postponed issues had been sold. The pattern of issues postponed in the fourth quarter of 1956 (estimated as 135 issues, valued at \$240 million) has been similar, with about 40 per cent sold to date.

For some borrowers, postponement has meant higher costs, for others it has proven advantageous. For example, the State of Michigan offered a highway bond issue in early December, with a maximum interest ceiling of 3.50 per cent. No bids were received. The issue was reoffered in reduced amount in mid-January, and successfully marketed at 3.37 per cent.

It appears that, for the most part, State and local governments last year were able to finance a very large and rising volume of expenditures and that the rise in interest costs of bond financing was a reflecting of supply and demand factors. There were some cases where borrowers were unwilling to pay current market rates, and withdrew their issues, and others where borrowers were prohibited by statutory limitations from paying rates which the market demanded.

2. "Are present statutory provisions governing reserve requirements satisfactory and desirable?"

The present system of reserve requirements is not altogether equitable in its impact on individual member banks. It has not seriously impeded, however, the effectiveness of monetary and credit policy in influencing the aggregate volume of bank credit. The problem of devising a more equitable and effective structure of reserve requirements has been under intensive study for many years, within the System, by the banking community, and by other students of monetary affairs, and many alternatives have been proposed and analyzed. It is one of the problems to be considered in any over-all review of the existing financial organization.

3. "Is the breadth of direct control (now limited to member banks) sufficient for the workings of general monetary controls, or should the direct influence of central bank operations be extended to cover other financial intermediaries, such as insurance companies, savings and loan associations, installment credit institutions, nonmember banks, etc.?"

Our experience of recent years indicates clearly that the actions of the System under its present authority are a potent force affecting financial developments in the economy. This is true both when stimulation of additional spending to achieve full utilization of resources is needed or when the problem is to achieve restraint on spending in order to avoid inflation.

Although the direct discipline imposed by the System through control over reserve requirements, the volume of reserves, and discount rates applies only to member banks, its ramifications are felt by nonmember banks, other financial institutions, and the financial markets generally. Federal Reserve member banks, with loans and investments of nearly \$140 billion, account for more than four-fifths of the assets of all commercial banks of the nation. Control over the rate at which new credit and money is created by this preponderant part of the banking system gives the Federal Reserve System a substantial influence on the total flow of loan funds, which includes those of individuals, savings institutions, businesses, and government, and also upon liquidity conditions in the economy. The operations of other financial institutions, particularly their ability and willingness to sell U. S. Government and other securities in order to advance new credit to borrowers, are substantially affected by changes in credit conditions brought about in part by Federal Reserve policies.

As we have pointed out in the past, the fact that reserve requirements of nonmember banks are defined differently and in many cases are ~~much~~ lower than those of member banks, creates some inequities and problems. These differences in reserve requirements may discourage some banks from seeking or maintaining member bank status. This situation is not new and no simple and practical way of making reserve requirements of nonmember banks consistent with those of member banks has been devised without an extension of Federal banking authority. The problems arising out of the situation are in some ways less pressing now than they were earlier in the postwar period, when the discrepancy between reserve requirements of member and nonmember banks was greater than it is now.

A policy of extending to nonbanking institutions a system of monetary controls analogous to that now applied to member banks by the Federal Reserve, however, would represent a basic and far-reaching departure from the principles that have in the past governed banking legislation and Federal Reserve policies. Commercial banks have special functions that are not presently shared by nonbank financial institutions. Before extending monetary controls over these institutions a careful study should be given to the far-reaching implications of such a departure.

4. "Is there any acceptable way of restraining the demand for loans without raising interest rates?"

We are not in favor of interest rates any higher than required by the underlying economic realities, but we do not believe that there is any practicable way of preventing them from increasing during those periods in which desired borrowings tend to outrun the flow of savings.

In order to keep interest rates below the level at which the amount of loan funds supplied is equal to the amount demanded, it is necessary to select some classes of potential borrowers and prevent them from borrowing, by law or regulation. Essentially, the problem is one of rationing, and involves many of the same sorts of difficulties and problems that have attended such programs in other areas. In a peacetime economy, there is no acceptable way of administratively determining who is to be permitted to borrow and who is to be forbidden.

Selective credit controls affecting the demand for credit have been used in certain areas where special considerations and conditions made them desirable and workable, and are now in use in one area, applying to stock market credit. The earlier controls over borrowing to buy houses and consumer durable goods were similar in nature. In each of these cases, however, there were special reasons for attempting to control the particular type of credit involved and some rough guides as to what would be reasonable objectives of control. Further, control of this kind was made possible by the special character of the borrowing, namely, that it was related to specific collateral and could be regulated (though imperfectly) by setting minimum downpayments and maximum margins and maturities.

Any attempt to extend similar controls to other types of borrowing, however, would be balked by much greater administrative difficulties, and by the problem of selecting the borrowers to be excluded from the market in a way that is equitable and makes economic sense. Who can say which business borrowers are to be permitted to have credit, and how much, and for what purpose? Which State and local governments are to be able to borrow? Who is to be permitted access to personal loans? An attempt to develop any system of general administrative rationing of credit in an effort to hold down the interest rates paid by those who were permitted to borrow would run into three kinds of difficulties: (1) it would create inequities, (2) it would require placing great power in the hands of the administrators, and (3) it would tend to undermine the flexible and progressive character of our economy. This would make it almost certain that any broad system of administrative rationing of all types of credit across the board would not be effective under peacetime conditions, but rather would become a force for inflation.

Even from the narrow point of view of its effect upon the level of interest rates, such a policy would be self-defeating. The greatest possible threat to the maintenance of reasonably low interest rates is inflation, and acceptance by the public of the idea that continuing depreciation of the dollar is to be expected. The reason for this is simple. If borrowers expect to repay their debts with dollars that are worth less than those borrowed, they are willing to pay high interest rates. If lenders expect to be repaid in dollars of reduced purchasing power, they will lend only at interest rates that are correspondingly high. Such

behavior has been illustrated in the extremely high levels reached by interest rates in countries undergoing inflation. Continued inflation, even if not of extreme proportions, must tend to cause high interest rates.

5. "Have you any general suggestions for revision of the present institutional arrangements in the field of money and banking, which would facilitate the use of general credit controls for economic stabilization?"

We are not convinced that our present institutional arrangements are altogether satisfactory; nor do we believe that Federal Reserve operations in the past have been entirely successful. Therefore, we will welcome a comprehensive study of our financial institutions and practices by a Congressional committee or by a monetary commission and will cooperate in every possible way with such a group. Meanwhile, we do not wish to propose suggestions for broad changes in institutional arrangements or techniques of control in the area of money and banking.