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See statements of Messrs [illegible]
& Mitchell

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Statement of

William McChesney Martin, Jr.

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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Mr. Chairman:

The focus of my remarks will be on the financial aspects of the economic situation and particularly on the role of monetary policy.

Individuals, business concerns and governments--national, state and local--obtained financing in record volume in 1962. Altogether, through borrowing and the issuance of securities, they acquired additional funds in the net amount of $58 billion. That surpassed 1959's previous record by $5.5 billion. It exceeded 1961 by $12 billion.

Mortgage loans registered a record expansion of $24 billion. Consumer credit outstanding showed a marked rise of $5.5 billion, three times as much as in 1961. Corporations cut back the issuance of bonds and stocks but stepped up their short-term borrowing. New borrowing by the Federal government equalled that of the previous year, while new borrowing by state and local governments continued in about the same record volume as in 1961.

A considerable part in supplying the financial needs of the nation was played by the banking system. Commercial banks increased their outstanding loans and investments by a record $19 billion. The increase in loans amounted to $14 billion; purchases of state and local securities accounted for the rest. The rate of expansion, 8 1/2 per cent for the year as a whole, was rising more rapidly as the last five months went by.

One particular display of enterprise by the banks seems worthy of special attention. The story behind it begins with the start of 1962 when, taking swift advantage of authorizations from the Federal Reserve and the Federal Deposit Insurance Corporation, banks in impressive numbers set out to gain deposits by raising the interest rates they pay for savings accounts and also for time deposits of six months or more.

The results were dramatic: the public responded to the higher rates by increasing its time and savings deposits some $15 billion, net, or 18 per cent--at an annual rate--a development unequalled in postwar experience. Also dramatic was the aftermath: the banks responded to the mounting inflow of funds by lending on real estate in an amount unmatched since the war and by purchasing state and local securities in a volume unprecedented in history. Meanwhile, in further reflection of the effect produced by the rising supply of savings, interest rates on mortgages and interest yields on state and local securities moved generally lower despite rising borrower demands. Thus, the flow of funds that was given impetus by the offer of benefits for savers brought about benefits for borrowers as well, and, I might add, for the entire economy.

To backstop and sustain that movement of funds--plus the still more massive process of total bank credit extensions--the Federal Reserve provided the reserves required to support the considerable expansion of deposits entailed. Indeed, it went beyond that, so that, at all times in 1962, the banks had an extra margin of reserves that would have enabled them to meet an even greater loan demand than actually materialized. Over the course of 1962, the Federal Reserve provided a total of $1.9 billion of reserve funds, through its payments for government securities purchased in the open market, to support bank credit and monetary expansion. For this purpose, it also released in late autumn another $750 million in bank reserves by reducing from 5 to 4 per cent the reserves required against savings and time deposits.

Bearing in mind that the course of the economy is determined by a whole complex of individual, business and Government decisions in which monetary policy plays only a modest part, it seems to me that the Federal Reserve System did just about what could and should have been expected of it in 1962. Monetary policy most certainly did not provide--nor could it have provided--a solution to the major economic problems which confronted us during the year. But it did contribute to credit conditions that were, I think, conducive to that end.

The American economy progressed in many respects in 1962. For the year as a whole, gross national product (in constant dollars) rose 5 per cent, industrial production nearly 8 per cent, nonagricultural employment 2 per cent, personal incomes 6 per cent, and corporate profits

12 per cent. Consumer prices rose 1.2 per cent during the year, but wholesale prices remained virtually unchanged.

Yet we continue to be plagued by relatively high unemployment and by a substantial deficit in our international balance of payments.

The number of people having jobs rose 1.2 million in 1962--and at the seasonal peak of employment last summer there were almost 70 million people at work suggesting that we may indeed top the 70-million-job milestone this coming summer. Yet the average rate of unemployment declined only to 5.6 per cent in 1962 from 6.7 per cent in 1961. Furthermore, despite an increase in industrial production to a level 8 per cent above the previous high in the first quarter of early 1960, the number of workers on the production lines of the nation's factories declined 500,000, or 4 per cent in the same period.

And even though continuing efforts to reduce the deficit in our international payments registered some success, the gap between our payments abroad and our receipts from international transactions continued large for the fifth consecutive year. In 1962, that deficit is now estimated at somewhat more than $2 billion, even though it was held down, as it had been the year before, by large pre-payments by foreign governments of long-term debt to the United States. Noteworthily, imports of merchandise, given impetus by expansion in the American economy, rose more than exports. In consequence, the trade surplus on which we count to help cover our military expenditures abroad, foreign aid programs, and our capital outflow narrowed to less than $4.5 billion in 1962, compared to nearly $5.5 billion in 1961.

Let me say here that providing a sound financial basis for healthy growth in the United States and maintaining international confidence in the dollar as a reserve currency are but two sides of one indivisible problem. There is no set of policies that is truly good for the domestic economy, but bad for the dollar; and there is no course of action that is really good for the dollar, as an international currency, which is not good for the American economy.

There is the tendency to speak of international *versus* domestic goals. This seems to me to be only the latest version of a series of problem-formulations in terms of unrealistic alternatives. Over the years, we have seen counterposed full employment *or* price stability, social objectives *or* financial objectives, and stagnation *or* inflation. In the last case there was even serious discussion of the number of percentage points of inflation we might trade off for a percentage point increase in our growth rate. The underlying fallacy in this approach is that it assumes that we can concentrate on one major goal without considering collateral, and perhaps deleterious, side effects on other objectives. But we cannot. If we were to neglect international financial equilibrium, or price stability, or financial soundness in our understandable zeal to promote faster domestic growth, full employment, or socially desirable programs, we would be confronted with general failure.

In the search for an appropriate policy in the monetary sphere, many factors must be weighed together to strike a balance. There is no ideal policy that will solve at one and the same time the balance of payments problem, the unemployment problem, and the growth problem, the wage-price problem, the profit squeeze problem, the housing problem, or any other problem--for none of these problems can be attacked in isolation through monetary policy.

As we enter 1963, the banking system continues to be in a favorable position to extend further credits. Taken altogether, the banks continue to have more reserves than they are required to carry, and only a very small fraction of these excess reserves are attributable to borrowing from the Federal Reserve System. In other words, the banks as a group have a considerable margin of "free reserves." They also have a sizable portfolio of near-term Government securities that they can use to raise further funds for loan expansion as opportunities to extend private credit arise.

In the language of the market place, the posture of monetary policy has been and remains "easy." At the same time, we have tried to avoid placing banks in a position which would impel them to reach beyond the bounds of prudence and good financial judgment in extending credit. We have tried to keep enough give in the credit structure to meet the growing needs of the economy, but not so much as to encourage speculative excesses. This program has served the dual purpose of maintaining the soundness of domestic credit developments, and at the same time lessening incentives to transfer short-term funds abroad.

Keeping day-to-day policy in consonance with these basic System objectives is a never ending process of evaluating the continuously changing scene, on both the domestic and international economic and financial fronts. One of the great strengths of the Federal Reserve System is that it has a seven-man Board of Governors and twelve regional Reserve Banks from which a wide variety of views is brought to bear on all monetary decisions.

Quite naturally, and I believe quite helpfully, there have been some differences of view in the System over the precise course of current action most likely to achieve the objectives upon which we have been mutually agreed. On several occasions some members of the Committee have felt that we would contribute more to the achievement of healthy expansion by increasing slightly the availability of reserves, while others have felt that the situation, particularly for balance of payments reasons, called for a modest move in the opposite direction. Yet the range of these differences was narrow and consequently the differences between the policies adopted and the alternatives proposed were, typically, quite small.

It is not my practice to attempt to forecast the future course of economic events or to comment on the monetary and credit policies that would be appropriate to them. Over the years I have found that viewing the economic prospects for the United States in the year ahead with cautious optimism is as good a working assumption as I have been able to discover. I agree with the statement in the President's Economic Message that the broad outlook is for continued moderate expansion.

Without in any way retreating from my position of cautious optimism, I would like to call attention to three things that concern me as I review our national situation and its prospects. First, the problem of financing the large Federal deficit that seems inevitable for fiscal 1964, whether or not the tax reductions recommended by the President are enacted. Second, the problem of finding an economically sound and workable program to reduce unemployment and to take care of those who, despite their efforts to find work, are caught in a maelstrom of economic forces that causes them prolonged joblessness. Third, and finally, the problem of achieving a satisfactory equilibrium in our balance of payments.

Let me take first the matter of deficit financing. As a widely read financial writer* put it--very well, I thought--in a recent column

> "The method of financing the deficit can (1) lay the base for another inflationary upsurge and weaken the dollar's value. Or it can (2) have some stimulating impact on the economy, just because the government is putting more money into our pockets than it is taking out in taxes. But it must not flood the business stream with extra money, set off another speculative spiral, or undermine the dollar's value here or abroad.
>
> "This is the crucial point, but it is so much in the sphere of technical high finance. . ." ---

and mind you I am still reading from the article ---

> "that very few people out of Washington grasp what it means.
>
> "Consider what is happening to this year's budget deficit.
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> "We are running a budget deficit now estimated at $8. 3 billion. Most of the money to cover this deficit already has been borrowed by the Treasury.
>
> "How has it been borrowed? Almost entirely outside of the banking system--which is the heart of the whole matter.
>
> "United States corporations have bought large amounts of the Treasury's short-term securities and have put their extra cash into Treasury I. O. U. s instead of spending it. Foreign investors and foreign central banks have bought big chunks of the Treasury's I. C. U. s and have been investing their extra cash instead of spending it. There is nothing inflationary about these operations at this time.

* Sylvia Porter, Washington Star, January 28, 1963

> "Had the Treasury borrowed the money from the United States banking system, though, the picture could be drastically different. For when banks buy the Treasury's securities, they simply place a deposit in the Treasury's name on their books; they put up only a fraction of their own cash. When these deposits in the Treasury's name are on the books of the banks, the Treasury has the money to spend.
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> "As the Treasury spends the money for goods and services, the extra cash goes into the hands of the public in the form of profits and paychecks. This means the nation has more buying power--and unless the supply of goods and services also rises, the base for potentially inflationary price increases is established.
>
> "Today, there are no shortages of goods and services. Today, the supply of money and credit is ample, but it is not flooding the business stream. The Treasury has managed its borrowing in a primarily non-inflationary way. The Federal Reserve System has kept its control over the money supply. The result is that price inflation is hardly a problem now.
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> . . . . .
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> "This year's $8.3 billion deficit is not causing inflation. Next year's deficit need not do so either. It all depends on how the deficit is financed."

As a comment of my own, let me add that, in my judgment, the Open Market Committee of the Federal Reserve System would be derelict in its responsibilities were it--in the light of a large deficit--to add to bank reserves and to bring about substantial credit expansion solely to facilitate the financing of the deficit. It would be improper to risk unsettling the balance of payments or to tempt banks to make imprudent investments through a sudden expansion of liquidity. Above all, it would be ill-advised to generate the danger of inflation, either long-run or short, by creating redundant dollars, in order to make easier the financing of a deficit.

In our system of government, it is the duty and responsibility of the Congress and of the President to make the decisions on government expenditure and tax policies by which the size of federal deficits is determined. Determination of those policies is not the responsibility of the Federal Reserve, but the System does have a responsibility in helping *to finance any deficits. It is the manner in which help is provided that* is critical.

So, seeing to it that the Treasury is able to carry out its borrowing operation in an orderly manner is an obligation binding upon the Federal Reserve. On the other hand, there is a reciprocal obligation on the part of the Treasury to conduct its operations with recognition of the Federal Reserve's responsibility for healthy credit and economic conditions, and for stability of the dollar. The Treasury obviously would not expect the Federal Reserve to inflate the money supply, thereby putting the entire economy in jeopardy, merely so that the Treasury could get money at an artificially low rate. So, with complementary responsibilities, the Federal Reserve and the Treasury must work together in complementary fashion. Neither can ignore the forces of supply and demand that are reflected in the market place. Instead, both must assess market forces and determine their policies accordingly.

The accommodation of the Treasury's financing needs, without disrupting the money and capital markets, is always one important objective of Federal Reserve policy. But this does not mean that bank credit should be expanded automatically by the amount of each Treasury issue that goes to market. Our objective at all times must be, as it has been in the past, to foster growth and employment, a stable value for the dollar, and equilibrium in the balance of payments.

This question of financing deficits has raised, and will doubtless continue to raise, troublesome semantic problems. The word "saving" has many meanings. As I pointed out to your Committee last summer, the total expansion of bank credit in our financial structure reflects both savings placed with banks as intermediaries and the creation of money through the expansion of demand deposits. After the fact of creation, these deposits become incorporated in our accounting of financial savings.

Once the semantic difficulties have been cut through, the difference of view among thoughtful people seems to me to be very small. I have never said that there should be no monetary expansion in a year in which the Federal Government is incurring a deficit, and, as the Council of Economic Advisers points out in its Report, no one seriously contemplated that the Federal Reserve should increase bank reserves in an amount equal to the deficit. What we should do, and will try to do, is to maintain conditions of reserve availability in the banking system, which will help to match the rate of total bank credit and monetary growth to the needs of the total economy. This is not financing deficits with bank created money. Nor is it offsetting or stifling any constructive impulse to economic expansion that may flow from tax reduction.

Let me turn now to the second of the problems I have singled out for special mention. Unemployment is a complex problem that has no simple solution. Many workers have gone through the cyclical ups and downs of the postwar period with little direct experience with unemployment, while some groups of workers have suffered severe hardship from it. Large clusters of unemployment have plagued certain communities, occupations, age brackets and racial groups.

The continuing high levels of persistent unemployment reflect a combination of demand and structural forces. We need a higher rate of sustainable growth to absorb the unemployed and provide jobs for a rapidly growing labor force, and fiscal and monetary policies can help to bring that about. But other measures are needed to deal with structural problems.

Unemployment is not merely a count of interchangeable units of labor. The unemployed are people whose characteristics and abilities vary greatly. The existence of high and growing levels of long-term unemployment among certain groups in our population in good times and bad indicates some very serious imbalances between the developing demand for labor and the existing supply.

Demands for labor must be sufficient in total terms. Eut the characteristics and location of workers who are seeking employment must also be suited to those demands. Actions taken to upgrade the work force, to increase its mobility and productivity, will make it much easier for unemployed workers and new workers to meet the requirements of rapidly changing technology and job demands.

In the recession-recovery periods since 1953 the same underlying employment patterns have recurred. Although total employment and industrial production rebounded in 1962 to new record levels, as after each of the preceding recessions, the number of factory and related industrial workers required to produce an increased volume of goods declined. In contrast, in service occupations, both private and public, em ployment has continued to expand and new employment records are set month after month.

As we look toward the future, two features of special importance may complicate efforts to achieve low unemployment. First, technological changes in the economy have had an important influence in sharply altering the character and content of job opportunities. These changes are bound to continue, perhaps at an accelerated pace. They foreshadow a further rapid upgrading in the demand for labor which will outpace the upgrading of the labor supply. The transition to new jobs will be slow and difficult for the displaced worker. Action will be needed to ease the burdens of those who become unemployed lest restrictive work practices reduce productive efficiency.

Second, we also face the inescapable challenge of a faster growing population of working age. Many more jobs will have to be found each year. About a million and a quarter persons are expected to be added to the labor force in each of the next five years compared to only about 800,000 in the past five years. By 1965, the burgeoning population of 18-24 years of age will account for more than half of the annual growth in the labor force. Unemployment rates are now very high among these young people, especially those with insufficient education. The long anticipated expansion in demand for homes, cars and all sorts of goods and services will hardly materialise if we fail to find job opportunities for our growing population.

The likely characteristics of unemployment caused by structural change in the coming years also indicate the need for a wide range of approaches by state and local governments, the educational system, the parties to collective bargaining and other private organizations. Foremost is the need for continued increases in the productivity and quality of our work force to meet the rapidly changing content of jobs. For our youth we must provide better vocational guidance and greater opportunities to get training for skilled and professional work.

Experimental programs for training and retraining unemployed workers have had some success in increasing skills and occupational mobility. Such programs should be given to more of the unemployed. More intensive efforts are required to get unemployed workers in depressed areas to areas where jobs are available.

The reduction in unemployment which we are able to achieve will continue to depend importantly on the success we have in shifting the composition of the labor supply to meet the changing needs of our economy. At the same time, of course, I recognize that we need also to pursue fiscal and monetary policies that will help to encourage growth in the total demand for our labor force. The important thing, as I stated to this Committee two years ago, is to proceed simultaneously, on the one hand, to invigorate the economy and, on the other, to alleviate unemployment resulting from structural changes.

Finally, let me comment briefly on our balance-of-payments problem. At the beginning of my remarks, I pointed out that balance in international payments is not a goal that monetary policy can pursue apart from its domestic goals. Indeed, the objective of payments equilibrium must be achieved at the same time we are achieving orderly and vigorous economic growth domestically or we will risk achieving neither objective.

As a result of five large successive deficits, we have transferred to foreigners some $7 billion from our monetary gold stock and added another $9 billion to our liquid liabilities. Through a combination of market processes and through some shifting in the balance of Government transactions, we have made progress in lowering the size of our deficit. But I agree with the view expressed recently by your Subcommittee, under the Chairmanship of Mr. Reuss, that this progress had not been satisfactory. Accordingly, we must more firmly pursue those policies that hold promise of eliminating our payments deficit and establishing a viable equilibrium in our international accounts.

The volume of Government expenditures abroad--for economic aid to the less-developed nations and for the defense of the free world--is and must be determined by broad considerations of national interest and security. The Administration has been pressing with some success for a greater sharing of these burdens by our allies. As your Subcommittee has recommended, continued efforts in this direction are certainly appropriate and will be made, I am sure.

But correction of the imbalance in our international transactions requires persistent improvement in the competitive position of our export industries and our industries competing with imports, and a related increase in the attractiveness of investing in the United States compared with investing in other industrial countries. This method can be effective only in the long run, but in the long run it is bound to be effective. Its accomplishment, however, requires the combined efforts of all of us.

Business management has a vital role to play because of its organizing role in a private enterprise economy. Businesses must meet the test of constant adaptation to the most efficient production techniques, and they must design and price their products with a view to the widest profitable distribution at home and abroad. Competitive pricing is vital.

Moderation in wage demands is also vital to our international competitive effort. Sustainable increases in wages can be achieved only within limits of realizable increases in productivity. And we need to remember that over-rapid increases in labor costs add to the problem of unemployment by creating exaggerated incentives to economize on the use of labor.

To me, an encouraging development of recent years has been an increasing awareness by both business and labor that these considerations--which were always in their own interest--are now urgently in the national interest because of our difficult payments position. Part of the progress we have been able to make in reducing the payments deficit since 1959 comes from the relative stability of prices and labor costs in this country as compared with those in Europe.

Our national financial policies have a vital role to play in strengthening our competitive position internationally, both in markets for goods and services and in investment potential. Fiscal policy will need to avoid, on the one hand, a too-heavy burden on economic incentives to invest and consume, and, on the other, budget deficits too large to be financed without inflation. Monetary policy will need to facilitate the meeting of legitimate bank credit demands in our growing economy, but it must avoid a domestic monetary expansion so rapid as to induce rising costs and prices, unwise speculation, and excessive capital outflows to other countries.

In connection with our balance of payments problem, we need always to keep in mind the central role that the dollar plays in the international payments system and the fact that this role is founded upon freedom from exchange restrictions. Whatever temporary advantage might be gained for our payments deficit by direct controls over our international transactions would be more than offset by the damage such controls would do to the widespread use of the dollar in settlement of international transactions.

With the economies of the Free World becoming more closely knit together by an international payments system based on convertible currencies and open competitive markets, cooperative international efforts are needed to restore and maintain payments equilibrium and to guard against disruptive exchange market developments. Fortunately, the need is widely recognized and the responsibility widely accepted.

This past year the Federal Reserve System gave formal recognition to this responsibility by inaugurating foreign currency operations under the supervision of the Federal Open Market Committee. This action put the System in a position to intervene in the exchange markets for the protection of the dollar under conditions of transitional unsettlement of those markets arising from volatile shifts in the stream of international payments.

The System has further supported its participation in foreign currency operations by cooperating more actively and directly with the central bank of our principal trading partners and with international organizations play ing a coordinating role in the functioning of the world payments system.

Because of our balance-of-payments situation, the newly inaugurated Federal Reserve operations in foreign currencies have concentrated this past year on the establishment of a network of mutual currency credit with other central banks, principally on a stand-by basis. We now have arrangements totaling more than $1 billion with the central banks of Europ and Canada and the Bank for International Settlements in Basle, which are capable at our call of providing foreign currencies to that amount if needed to meet undesirable exchange market developments. It is our hope that these arrangements will remain a useful international device and a continuing symbol of active cooperation in preserving and strengthening the world payments system.

Closer cooperation among leading central banks has already contributed much to greater resiliency and flexibility of the world's payments mechanism. This was demonstrated in 1962 by its absorption of the shock of sharp world-wide decline in equity values in the late spring and early summer, of the potentially disruptive effects of the difficulties encountered by the Canadian dollar following its devaluation in the spring, and of the unsettlement of international markets occasioned by the Cuban crisis. And to the extent that the world's payments system absorbed these adverse developments with little unsettlement, the impact of these developments on the domestic financial markets was also cushioned.

From my remarks today, it should be clear that the year 1963 will confront us with important and difficult problems. We must work toward a solution of structural unemployment at the same time that we generate more aggregate demand for our manpower by healthy over-all expansion of the economy. We must finance our prospective deficit in a noninflationary way. And finally, we need to make decisive gains in restoring our balance of payments equilibrium. If your review a year hence shows substantial progress in meeting these problems, it will indeed be a gratifying occasion.

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