August 1963 Bulletin p. 106
see also Gov Robertson's statement

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

July 22, 1963

It is my understanding that the primary purpose of your hearing is to discuss the recent actions by the Board approving changes in Reserve Bank discount rates and increasing the maximum rate payable by member banks on certain time deposits. I should like to submit for inclusion in the record at this point a copy of the Board's official announcement of these actions.

By way of introduction, let me first express a personal view as to the present posture of Federal Reserve policy. In my judgment, Federal Reserve policy has been and continues to be easy and stimulative--moderately less so than it was earlier, but still quite positively balanced on that side of the scale.

We are, of course, dealing in an area of judgment, and other judgments may and do differ from my own. There are, however, various relevant facts in support of my view.

First, bank credit has continued to expand vigorously. Commercial banks extended an additional $11 billion of credit in the first six months of this year, an annual rate of growth of 10 per cent. About half of the gain was in loans and half in investments.

Second, bank deposits have increased similarly. As in other recent periods, a large part of the increase has been in time and savings deposits, which in the first half year grew at an annual rate of 14 per cent. At the same time, the narrowly defined money supply

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(demand deposits and currency) has also increased at an annual rate of 2-1/2 per cent--somewhat more than the rate for last year as a whole.

Third, consumer and mortgage credit have both expanded rapidly, and are, of course, at record highs. In the last twelve months we estimate that consumers borrowed an additional $22 billion to finance the purchase of homes, autos and other durable goods.

Fourth, credit to finance purchases of equity shares has risen more than a billion dollars in less than a year.

Fifth, member bank excess reserves are still substantial, and member bank borrowings are moderate. For more than three years, the banking system has had more excess reserves than borrowings and it continues in that position today, with free reserves currently in the neighborhood of $150 million.

Sixth, the total reserves of member banks, which provide the base for bank credit expansion, have continued to rise. After allowance for seasonal factors, the increase in the first half of 1963 was $265 million, an annual rate of increase of nearly 3 per cent.

Seventh, a 3-1/2 per cent discount rate is not high in relation to discount rates prevailing elsewhere in the world. Only two important financial markets (Germany and Switzerland) have lower rates.

Eighth, many longer-term rates--especially those on mortgages, corporate bonds, and State and municipal issues--are lower today than they were earlier in the present period of recovery and expansion.

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All this hardly seems to me to add up to a situation in which credit conditions could be characterized as tight or restrictive. On the contrary, credit-financed expenditures have been--and are--playing a very important role in stimulating the domestic economy; perhaps even overstimulating it in some areas.

The statistics I have just cited are also supported by the observations of both lenders and borrowers. I cannot recall a time in recent years when lenders have been so aggressively seeking employment for their funds. In every part of the country, individual businessmen, engaged in both large and small enterprises, tell me that banks and other financial institutions are actively urging them to come in for loans to expand their operations.

Economic conditions have continued to improve. Industrial production made still another record high at mid-year, one-fourth above the 1957-59 average, and well above the level generally anticipated at the turn of the year. The expansion in the gross national product is pressing hard against the upper limit of the range projected by the Council of Economic Advisers in its January Economic Report. While still insufficient to make inroads on the unemployment percentage, the gains in employment have been substantial and are larger than many expected to be realized by this point.

The Board's actions last week, in approving an increase from 3 per cent to 3-1/2 per cent in the discount rates that member banks

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must pay on borrowings from the Federal Reserve Banks and in raising to 4 per cent the rates that member banks may pay their customers on time deposits of 3 to 12 months duration, were taken only after long, careful and conscientious consideration by the Board and, indeed, by the entire System, in which every aspect of the question and every point of view was developed and weighed. In the end it was determined, as the Board's announcement pointed out, that these specific actions were essential to aid in the United States' effort to meet its international payments problem, particularly that portion occasioned by short-term capital outflows.

As you all know, I regard the problem of the balance of payments as vital, and I am convinced that our failure to solve it up to now has not only been damaging to our international relations but also has impeded the achievement of even higher levels of output and resource utilization in our domestic economy. Consequently, I am pleased that the Administration has launched a vigorous program on a broad front to reduce the payments deficit.

But this is a problem for every American, and none of us bearing responsibilities to the American people can simply pass it to the others to solve--if and when they conveniently can. Time is pressing and we will do better to be active now than alarmed later.

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The international payments problem confronting us is not a passing, transitional thing that will shortly go away if we only wait patiently for it to disappear. The biggest and best bank in the world could not count on others to keep adding to their balances with it indefinitely, without regard to their own cash needs and alternative uses for their funds, and it would be neither wise nor safe to do so.

With the single exception of 1957, when U. S. exports burgeoned in the wake of the world crisis over Suez, the United States, year in and year out for a dozen years, has been witnessing a persistent build-up of its short-term liabilities to foreigners. Cumulatively, this build-up has amounted to $17 billion--even after we have paid out $8 billion in gold in consequence of the perennial deficit in our international payments accounts. In 1963, that deficit in our accounts still persists, and it is not growing smaller. In the first six months of this year, it reached an annual rate perhaps as large as $3-1/2 billion, excluding special Government transactions. Outflows of short-term capital, to which the Board's action was particularly directed, have been contributing materially to this year's deficit.

These flows reflect many types of transactions. Not all of them are responsive to moderate changes in U. S. short-term interest rates.

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But four kinds of short-term capital movements are likely to be sensitive to rate changes. These are:

(1) Placement of liquid funds by U. S. corporations in the so-called Euro-dollar market, i.e., in interest-bearing dollar deposits with foreign banks;

(2) The flow of U. S. funds into money markets abroad (mainly in sterling and Canadian dollars);

(3) Acceptance credits for the account of foreigners to finance trade between foreign countries;

(4) So-called "leads and lags" in commercial payments, i.e., the tendency of merchants to delay or speed up the payment of debts for imports, or the collection of debts for exports.

Unfortunately, we do not know as much about these flows of funds as we would like to know. But it may be helpful to sketch briefly what we do know, and what we may reasonably infer about them.

(1) Clearly, the flow of U. S. funds into the Euro-dollar market is primarily motivated by the higher yield available to U. S. corporations on dollar deposits with foreign banks than on domestic deposits or money market paper. Only a fraction of these transactions appear in the statistics on recorded capital movements. When the treasurer of a U. S. corporation decides to put some money on deposit with, say, a Canadian commercial

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bank, his transaction appears in U. S. statistics as a short-term capital outflow only if it is handled by a U. S. financial institution or if the corporation is one of the relatively few large ones that report their foreign transactions each quarter. Otherwise, the transaction only serves to increase the "errors and omissions" item in balance-of-payments statistics. In view of our close financial and economic relations with Canada, and the fact that many comparatively small companies do business regularly in both countries, we are certain that many transactions are unrecorded. The same thing is true, to a lesser extent, of transactions with other countries.

(2) Patently, the flow of dollars into British, Canadian, or other foreign money market instruments is motivated largely, if not exclusively, by higher yields. Again, only a fraction of these movements is likely to go through U. S. financial institutions. Still, bank-reported claims on foreigners that are denominated in foreign currencies alone rose $70 million in the months from February through May.

(3) U. S. bankers' acceptances to finance trade between foreign countries have increased $150 million from February through May. It is true that variations in the volume of such acceptances reflect influences other

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than rate differentials. But obviously the question whether acceptance credit in the United States is more or less expensive than in other financial centers, and especially in London, is likely to play a decisive role in determining whether or not a foreign merchant or banker will resort to the U. S. market.

(4) Changes in the "leads and lags" in payments for exports and imports also reflect factors other than interest rate considerations, such as weighing the exchange risks involved. But an importer's decision whether to seek his financing at home or abroad will be influenced at least in part by relative interest costs. Unfortunately, statistics on this subject are again incomplete because only a fraction of such financing goes through U. S. banks. Still, "collections outstanding" as reported by U. S. banks rose $60 million from February through May.

To sum up, that part of the interest-sensitive short-term capital outflow that goes through U. S. financial institutions and therefore is reported on a reasonably current basis and to a reasonably complete extent, amounted to nearly $300 million in the months from February to May. No doubt, unreported movements of this type were also large.

Of course, not all movements of interest-sensitive funds should be solely attributed to interest-rate considerations. Thus, on the one hand, the reported figure understates the short-term capital outflow

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responsive to interest-rate changes because it obviously cannot include unrecorded flows. On the other hand, the reported figure overstates the interest-sensitive outflow because it does not exclude those movements attributable to other considerations, such as changes in market attitudes toward the dollar. Weighing these two opposing considerations against each other, it seems reasonable to regard the $300 million figure as a rough indicator of the magnitude of interest-rate-sensitive flows of short-term funds in the four months, February through May. This was perhaps one-fourth of the over-all U. S. payments deficit in that period.

You will understand that the interest rate sensitivity of these flows refers primarily to rate relationships rather than to absolute levels. Moreover, in the case of movements of money market funds, the determining factor is frequently, if not exclusively, the "covered" interest differential, i.e., the difference between interest rates adjusted for the forward premium or discount on the U. S. dollar.

Plainly, the effects of a change in U. S. rates could be weakened if foreign short-term rates (including Euro-dollar rates) moved with U. S. rates. In the case of money market funds, moreover, the effects could also be weakened if the forward rates on the U. S. dollar declined when short-term rates rose here. But fully offsetting movements appear unlikely.

Increased confidence in the dollar in itself, quite apart from technical rate relationships, may well result in some reflux of funds previously invested abroad. Hence, the gains for our over-all balance of payments might turn out to be larger than the losses occasioned by our recent short-term capital outflows.

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As Secretary Dillon pointed out in his testimony before the Joint Economic Committee, the effect of higher U. S. short-term interest rates will not be confined to those flows that influence the U. S. payments balance. The higher level of short-term rates is also likely to make foreigners more willing to keep dollar receipts invested in the United States rather than to convert them into their domestic currencies. This means that the remaining U. S. payments deficit could be financed to a larger extent than hitherto by the accumulation of foreign dollar balances in private hands rather than in the hands of central banks, which might use their dollar holdings to buy gold.

Thus, in conclusion, there can be no doubt that a rise in U. S. short-term interest rates will have a significant effect on the international financial position of the United States. The magnitude of this effect, however, will depend upon many imponderables, such as the psychological reaction in money markets at home and abroad, the pace of further expansion of the U. S. economy, and especially the effectiveness of other steps being taken to help reduce the present payments deficit.

The Board's recent actions are an essential part of a total effort to bring to an end the U. S. payments deficit, with its harmful effects on the domestic economy as well as on the international standing of the United States. While this process is underway, it is essential that monetary policy remain flexible and uncommitted--free to move either to check an unwanted and inappropriate tightening of credit, should it develop, or to defend more aggressively the international position of the dollar, should that be necessary.

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