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Statement of

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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Mr. Chairman:

My remarks today will be directed primarily to financial developments, for there is little I can add to the more general reviews of the economy's progress which you have already heard. I share fully the satisfaction others have expressed about the achievement of a fourth year of vigorous expansion in the output of goods and services. And I am also pleased that we were able to show further progress in reducing, at least a little, the unemployment rate. That we accomplished so much within a general framework of price stability is a matter for special gratification.

As has been brought vividly to our attention in recent weeks, our slow progress toward a solution to our balance of payments problem has not been so gratifying and failure to bring about a significant improvement constitutes a challenge of first importance to our national well-being. The whole posture and effectiveness of our foreign economic policy hinges on world confidence in the dollar. But let me return to this problem later in my remarks.

To assess with precision the role of one segment of public policy in the broad sweep of economic developments is always difficult. For example, we all speculated before the fact as to what might be the impact of the tax changes which went into effect last year. Even with the benefit of hindsight, it is very difficult to say how much of the expansion in activity last year flowed directly from the stimulus of tax reduction. It is equally difficult to say what part monetary policy

played in last year's economic advance. Assessments of this kind will always be matters of judgment. But I think we can agree that both fiscal policy and monetary policy contributed positively to the year's outcome.

As to credit market developments during 1964, there was relatively little change over the year in either the availability of credit or the cost of credit in markets which are most closely related to domestic economic activity.

Total funds raised last year amounted to a little over \$71 billion--up from about \$62 billion in 1963, and \$58 billion in 1962. The pattern of flow within this sizable increase in the total was roughly comparable to that of other recent years.

To take a few examples, the Federal Government raised about \$6 billion in the calendar year, as compared with \$4.8 billion in 1963, and \$7.5 billion in 1962. Consumer credit increased \$6.7 billion--the same amount as 1963, and more than the \$5.5 billion in 1962. State and local governments added \$6.5 billion to their indebtedness, as compared with \$6.7 billion in 1963, and \$5 billion in 1962. Additional borrowing on one- to four-family home mortgages amounted to about \$16 billion, as compared to \$15 billion in 1963, and \$13 billion in 1962. As you can see, all of the figures for 1964 are in roughly the same order of magnitude as those in other recent years and the over-all increase is widely distributed.

Much the same observation might be made with respect to the sources of funds. The flow of financial savings in the form of time and savings deposits at commercial banks and at other savings institutions remained high and little changed, amounting to about \$29 billion in 1964, as compared with \$28 billion in each of the preceding two years. Private insurance and pension fund reserves increased by \$10-1/2 billion last year, as compared with about \$10 billion in 1963, and \$9 billion in 1962. Direct financial investment by the public was larger than in other recent years--\$14 billion, as compared to around \$10 billion in 1963 and \$9 billion in 1962. Generally we see that the changes which occurred in the pattern of savings flows were not dramatic, although the year-to-year gains were varied. Increases in the public's holdings of demand deposits and currency financed \$6.1 billion of the total flow, as compared with \$5 billion in the preceding year. This was related to a 4 per cent increase over the year in the conventionally defined money supply, as compared with 3.8 per cent in 1963.

As I have already suggested, these shifts in the flow of funds were not accompanied by any change in the structure of interest rates or in credit availability of great significance for the domestic economy. The yield on long-term U.S. Government bonds fluctuated between 4.11 and 4.20 per cent, and was close to the middle of that range at year-end. Yields on Triple-A State and local government issues fluctuated in a range of 2.99 to 3.16 per cent, and ended the

year at the low point of that range. Triple-A corporate bonds moved between 4.35 and 4.45 per cent, closing near the top of the range. After moving in a very narrow range throughout most of the year, the rate on 90-day Treasury bills rose in the fall, especially in conjunction with the change in the Federal Reserve discount rate in late November, and at year-end it was near the top of the 3.43 - 3.36 per cent range for the year as a whole.

I believe it is fair to say that the very moderate changes in long-term yields and in fund flows reflected primarily the interplay of market forces and not the modest changes that were made from time to time in monetary policy, primarily with a view to maintaining as firm conditions as practicable in the short-term money market for balance of payments purposes. However, the over-all effect of our policies was to permit credit to expand in response to the demands of a vigorously growing domestic economy without significant upward adjustment of the cost or contractive adjustment in the availability of credit.

At the time, this policy seemed to me to be the most appropriate one and, in retrospect, it still seems to me to have been appropriate. I am reasonably certain that a more stimulative monetary policy would not have been desirable. It is not equally clear to me that even in terms of domestic developments alone we may not wish we had exercised somewhat more restraint, especially on the very rapid growth of money and credit which occurred during the early summer. Since that time the rate of expansion in the money supply has, in fact,

moderated, and the rate of bank credit expansion has been closely geared to the inflow of time and savings deposits. We may suspect that credit growth in 1964 facilitated unsustainably high rates of activity in some areas, and to the build-up of dormant but dangerous pools of liquidity in the economy, but it is not yet evident that this was the case.

There is evidence that the high rate of credit growth last year, as well as in the immediately preceding years, was not accomplished without some deterioration in the quality of credit. In itself this is not a cause for alarm. As institutional lenders have been pressed to employ the large flows of funds that have come to them it was to be expected that they would make some loans on more liberal terms than were heretofore acceptable. So long as these are scattered in well-balanced portfolios and protected by adequate reserves, they do not endanger the financial structure. But if they are concentrated in some institutions or in certain local areas they can cause real trouble. I believe that the financial community is now fully alert to this problem and its potentialities--but we must be careful in our monetary policy not to encourage lending practices that, in the supervision of financial institutions, we seek to prevent. Too much pressure to expand aggregate demand through additions to the flow of funds in credit markets could have this effect.

Economic developments are never exactly as one might wish them to be--and some maladjustments are no more than evidence of necessary and desirable changes that are part of the growth process.

The shifts of capital and other resources from obsolete to more productive uses that are essential to growth are smoothed and speeded by the ready availability of credit. I believe our policies helped the credit mechanism to perform this useful function in 1964. In other words, I think that monetary policy did what it could and should do to facilitate healthy economic growth within the United States. In our effort to try to do all that we could, I only hope that we did not do a little more than we should have.

Whether it could have or should have, it is now clear that monetary policy did not prevent a large increase in capital outflows from the United States in 1964. While it is true that we were still able to show some modest improvement by reducing the deficit from \$3.3 billion in 1963, to \$3.0 billion in 1964, the substantial improvement that we all hoped for and might otherwise have achieved was wiped out by a dramatic rise in capital outflows. Total capital outflows increased by almost \$2 billion--from about \$4 billion to about \$6 billion. Had it not been for this increase, our deficit would have dropped to \$1 billion--progress that would have been generally regarded as encouraging, both here and abroad.

The large increase in our capital outflow was associated with a substantial advance abroad in both short- and long-term rates and a marked curtailment in the availability of credit in major foreign markets. At the time we were experiencing this mounting capital outflow, an adverse payments balance for the United Kingdom put the pound sterling under strong pressure in international markets

resulting in further large drains on Britain's monetary reserves. That country was obliged to take a number of emergency steps, including the establishment by its central bank of a discount rate of 7 per cent. To support the pound in international markets, the Bank of England arranged credits with other central banks and the IMF amounting to about \$3 billion.

In these circumstances and in recognition of the advances in short-term rates that had been occurring in other international markets, the Federal Reserve discount rate was raised from 3-1/2 to 4 per cent. At the same time ceilings on the interest rates that banks are permitted to pay on time deposits of over 90 days were raised to 4.50 per cent. Short-term rates in our money market promptly moved upward about a quarter of a per cent in adjustment to these changes. It is impossible to say how large the capital outflow in the fourth quarter might have been if we had not taken the actions when we did. All that we know is that in spite of whatever inhibiting effect may have come from these actions, and the accompanying rise in short rates, there was a further rise in lending and investing abroad.

I realize that it is always possible to play a sort of numbers game with the balance of payments statistics, in which one can show that a substantial reduction in any important component of the gross flows of funds abroad would wipe out or drastically reduce our deficit. This is true of foreign aid, of our military expenditures overseas, of tourist expenditures, and so on. The important fact to bear in mind

is that it was our capital outflow that rose so spectacularly in recent months.

This is why the President's program to correct our balance of payments deficit places special emphasis on capital flows and on bank lending in particular. Bank lending last year increased by over \$1 billion, bringing it to double the rate which prevailed in 1963, and about quadruple the 1962 rate.

In the light of these facts, it seems clear to me that the program launched by the President addresses itself to the core of the problem. To accomplish its ends, it is relying heavily on voluntary cooperation by banks, other financial institutions, and nonfinancial businesses. The Federal Reserve System has a major role in this program and is already pursuing vigorously its assignment from the President.

It is no secret that some skepticism has been expressed both here and abroad as to whether such a voluntary program can succeed. No one can say for sure until we try.

The advantages of this voluntary approach are obvious. It interferes less drastically with the principles of our economy, based on private initiative and the market mechanism, than would a system of direct controls. It can be put into effect much faster than taxes or statutory regulations on overseas lending and investment, and it can be much more flexible in dealing with special situations. While it does not relieve us of the necessity of pursuing fiscal and monetary

policies appropriate to the correction of our payments deficit, it may permit somewhat greater latitude in adjusting such policies to stable and sustainable domestic economic expansion. The risk is equally obvious. We cannot be certain that we will obtain, voluntarily, the cooperation which is essential to the success of this sort of program.

Bankers and other businessmen feel, as they should, a strong sense of responsibility to maximize the earnings available to pay interest and dividends to their depositors and shareholders. But more and more, it seems to me, they are prepared to interpret this responsibility broadly and to recognize that policies which are in the national interest may be more beneficial to them, even though they may not maximize profits in the short run. I am encouraged by the response we have had thus far. The bankers and others with whom I have discussed the program seem not only willing but determined to make the program a success.

Nevertheless, I think we must all follow the progress of this program and related developments in our balance of payments closely as the year progresses. If at any point it appears to us that we are not making the gains envisaged in the President's Message, we must all be prepared to take whatever additional measures are needed, including of course, a less expansive over-all credit policy. There is no doubt in my mind that 1965 must be a year in which we show substantial progress toward the solution of our balance of payments problem.

Let me say a few words about economic developments since the turn of the year. Unfortunately, our ability to judge the underlying

trends in the economy is complicated by an extended dock **strike** that has paralyzed shipping at East Coast and Gulf ports, and by the prospect of a work stoppage in the steel industry.

In the aggregate, we do know that economic activity has continued to rise. Following the large gains in November and December, when auto output recovered from strikes, industrial production rose somewhat further in January. Unemployment edged down to 4.8 per cent. Bank credit rose vigorously, reflecting a large inflow of time and savings deposits that appears to be continuing in February. The money supply expanded moderately in January--at an annual rate of about 3 per cent--but showed no further growth in the first half of February. We know from experience, and I would warn you, that very little significance should be attached to week-to-week and even month-to-month fluctuations in this rate, however. Movements in one direction or the other often reverse themselves in the subsequent period.

Conditions in money markets have firmed somewhat in recent weeks and the three-month bill rate has moved up close to the 4 per cent discount rate. As those of you who have heard me discuss the subject before are well aware, I feel strongly that too much emphasis should not be placed on free or net borrowed reserve figures as indicators of monetary policy. Nevertheless, let me just mention that free reserves have been somewhat lower on average and we did report a minus figure in one recent week. The more meaningful observation, I think, is that the whole complex of factors that make

up what we call the tone and feel of the market have been slightly firmer. While there has been some uncertainty as to market prospects for longer term securities, actual prices have moved very little and the average yield on long-term Government bonds is still close to the level that prevailed at the turn of the year.

Commodity price behavior is perhaps the most difficult of all developments to interpret with confidence. For the last several years there have been efforts from time to time by suppliers of industrial materials and products to make upward price adjustments. More often than not these efforts failed, with the result that over-all averages remained substantially unchanged. Since the middle of last year, when market prices of sensitive industrial materials moved up further, more of the price increases in industrial products have held than was the case earlier, and as a result the averages of both industrial material and product prices have edged up. Thus far, the movement in these averages could certainly be described as moderate, and the tendency for more price increases to stick may be related to the high rates of activity in some lines, associated with steel strike anticipations. When this added stimulus is withdrawn or reversed, even the mild uptrend that we have seen recently may disappear.

Having said this, let me add that I cannot avoid the feeling that we have been, and still are, sailing very close to the edge in this area. Expectations play an important role in price behavior and the expectation of continuing price stability is vital to its current realization.

As I have said many times, inflation is a process and not just a condition. We must expect that markets will continue to be tested and that if we fail to maintain a situation which is conducive to price stability, we could find ourselves caught up very quickly in an inflationary spiral. Such a development would seriously threaten both our program to bring our international payments into balance, and the prospects for continued expansion in our domestic economy.

There is, inevitably, an element of "brinksmanship" in our laudable efforts to push our economy closer and closer to its full potential without straining it. It will require the best efforts of all of us to achieve balance in both our internal and international economic affairs in the year ahead.