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Statement of  
William McChesney Martin, Jr.,  
Chairman, Board of Governors of the Federal Reserve System,  
before the  
Subcommittee on National Security and International Operations  
of the  
Committee on Government Operations  
United States Senate

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A strong, healthy American economy is vital to our national security--both because it provides the means with which we defend ourselves and because our influence in international affairs is inextricably related to our own economic performance.

The Federal Reserve System has a host of duties and responsibilities related to the supervision of banks, the performance of fiscal agency services for the Treasury, and the efficient functioning of the payments mechanism in the United States, but far and away its major responsibility is to encourage, as best it can with the tools at its disposal, financial conditions which will, in turn, contribute to vigorous, sustained growth in output and employment. In other words, our overriding objective is to strengthen the U. S. economy.

I have spoken thus far of the strength of the American economy without making any special reference to the strength of the dollar as an international currency or to our balance of payments. As some of you probably know, to me these are part of the same package. We cannot have a strong economy without a strong dollar. In the long run, equilibrium in our international accounts is just as essential to our domestic prosperity as it is to the dollar's position in international commerce. It would be utterly unrealistic to think that we could have lasting prosperity in this country if we had a weak dollar, and consequently a deteriorating confidence around the world in the United States and its economic system.

Let me say just a few words about what the Federal Reserve System can do and what it has been doing to help bring about the kind of financial climate that is conducive "to maximum production, employment and purchasing power"--the objectives of Government economic policy as set forth in the Employment Act of 1946.

Basically, our influence on economic developments stems from our authority to specify the amount of reserves that banks are required to hold and our control over the supply of these reserves. Because of short-term fluctuations in factors beyond our control, we cannot determine precisely the amount of reserves that are available to banks each day, or even each week; but we can offset these fluctuations in the longer run, and it is fair to say that from month to month and year to year the supply of reserves is determined by the policies of the Federal Open Market Committee.

We could undertake to regulate the growth of reserves available to banks in accordance with some set formula. As a practical matter, however, the Committee exercises its regulative influence by establishing and maintaining conditions as to the cost and availability of reserves befitting current economic needs. With this approach, the growth of bank reserves reflects in part market factors, which depend in turn on the strength of credit demands within the economy.

Regulation of the supply of reserves available to commercial banks has an influence on the cost and availability of credit and on the rate of growth in money and credit, which affects in turn the aggregate demand for goods and services. But these variables are also influenced by many other factors, and the impact of moderate changes in monetary policy is often hard to identify, much less quantify. Even fairly drastic changes in our policies may at times be overshadowed by the sweep of other developments.

Let me digress here to say that our own staff and many other economists working independently are laboring continuously--aided considerably by the advances in recent years in computer technology--to isolate and measure more exactly the impact of changes in policy at various stages of this process so that we may think and speak with more precision about the ultimate effects of policy changes. In the meantime, the precise magnitude and timing of these effects are not subject to exact scientific determination and so remain a matter of judgment, and one on which judgments may differ.

I am stressing these limits of our knowledge in order to explain why central banking remains an art rather than a science. And as an art, it is the art of moderation, or the middle way. At all times, we must be aware of the risk that the economy might be undermined by either deflation or inflation.

What the Federal Open Market Committee does in performing its policy-making functions, can be described in infinite detail, but it can also be summarized accurately, I think, in a very few words. The Committee issues directives to the Manager of the System's Open Market Account as to the conditions of reserve availability which, in its best judgment, will be most conducive to the sound, healthy growth of the economy. Most often, over the years, there has been a substantial unanimity in the Committee as to the directive most likely to contribute to this end. Occasionally there have been sharp differences of view, but these have usually come at times when the future course of economic events was especially hard to divine, and our thinking has tended to come together again as the situation clarified.

Thus far I have described our functions and their relation to what I understand to be your interests in very general terms. I surmise from your initial memorandum and your previous hearings that it would be appropriate for me to tell you about our activities in the international field in a little more detail.

Let me say, first of all, that the Federal Reserve has neither the authority nor the inclination to make foreign policy of any kind, including foreign financial policy. As a member of the National Advisory Council on International Monetary and Financial Problems, I am called upon to advise the President on those problems. But the United States has, and can have, only one foreign policy. Any action the Federal Reserve may take in matters connected with foreign relations, any negotiation or discussion with foreign central bankers, any participation in international activities, institutions, or meetings--in short, anything we do or say in this area is carefully coordinated with those Government agencies to which the President has delegated authority, and on occasion directly with the White House.

But within the framework of U.S. foreign financial policy, and with the full approval and indeed encouragement of the Administration, the Federal Reserve has greatly expanded its international activities in recent years. These activities include three different, though interconnected, categories: first, participation in international meetings, discussions, and negotiations in which representatives of the Federal Reserve form part of a U.S. delegation; second, a wide range of informational contacts, formal and informal, with foreign central banks;

and third, arrangements with foreign central banks on foreign exchange operations.

Federal Reserve representatives, acting as members of a U.S. delegation, have played important roles in meetings and negotiations connected with the International Monetary Fund, with the so-called Group of Ten, and with the Organization for Economic Cooperation and Development.

Federal Reserve connection with the work of the IMF started even before that organization was established: members of the Board of Governors and of its staff participated in the drafting of the proposals that led to the Bretton Woods Conference of 1944, and in the work of the Conference and the drafting of the IMF Agreement itself. More recently, they have regularly formed part of the U.S. delegation at the annual meeting of the IMF, and of the group of officials that consults every year with the IMF on economic and monetary developments and policies in the United States.

Federal Reserve officials also play an important role as members of the various U.S. delegations in the so-called Group of Ten, which includes the ten leading member countries of the International Monetary Fund. This is the group of member countries that agreed in December 1961 "to lend the Fund amounts of their currencies up to a total of \$6 billion, so as to reinforce the Fund's ability to grant drawings to participants in the Arrangements in order to forestall or

cope with an impairment of the international monetary system."<sup>1/</sup> By Act of June 19, 1962, the Congress authorized the United States to participate in an amount up to \$2 billion in these Arrangements.

The Ministers and Central Bank Governors of these ten countries, together with the Managing Director of the IMF, decided in October 1963 to review the functioning of the international monetary system and the probable future needs for international liquidity. They instructed their Deputies to examine these questions and to report on the progress of their studies. The Secretary of the Treasury, as the U.S. member of the Ministerial group, appointed the Under Secretary of the Treasury for Monetary Affairs and a member of the Board of Governors, Mr. Daane, as his Deputies. These U.S. Deputies, and their counterparts from the central banks and finance ministries of the other countries of the Group of Ten, have been responsible for constructive work on the international payments problem, especially for important studies on problems of reserve assets and other matters of vital importance for any appraisal and reform of the international monetary system. Staff members of the Federal Reserve have participated, and still are participating, in the studies undertaken by the working parties of the Deputies.

Further, Federal Reserve officials form part of the U.S. delegations to the meetings of the Economic Policy Committee of the OECD--the

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<sup>1/</sup> Annex to the Ministerial Statement of the Group of Ten of August 10, 1964, section 16 (f).

successor to the organization set up to help implement the Marshall Plan--and of its working parties. From the point of view of the Federal Reserve, the most important of these groups is Working Party 3, which periodically discusses the balance-of-payments problems and policies of the participating countries.

These discussions in WP-3 are valuable as means of conveying information and fostering mutual understanding. But they have acquired particular significance since WP-3 has been charged by the Ministers of the Group of Ten with the task of providing "a basis for multilateral surveillance of the various elements of liquidity creation, with a view to avoiding excesses or shortages in the means of financing existing or anticipated surpluses and deficits in the balance of payments, and to discussing measures appropriate for each country in accordance with the general economic outlook."<sup>2/</sup> WP-3 has also been charged by the Ministers with the task of undertaking a thorough study of the measures and instruments best suited for averting large and persistent payments imbalances.

Meetings of Federal Reserve officials with other central bankers take place periodically within the framework of the Bank for International Settlements and the Center for Latin American Monetary Studies, which is known by the initials of its Spanish title as CEMLA. The Federal Reserve, in accordance with then prevailing U.S. policies, declined formal membership in the BIS when it was first established. But it has more recently, in accordance with contemporary U.S. policies,

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<sup>2/</sup> Annex to the Ministerial Statement of August 10, 1964, section 37.



accepted the invitation of the BIS to send observers to the monthly and annual meetings of the central bankers that form its Board of Directors. These meetings do not result in policy decisions but they permit a frank exchange of information and opinions among central banks which are useful in many ways. One of the members of the Board regularly attends the annual meeting of the BIS members. At the monthly meetings the Federal Reserve is usually represented by officials of the Federal Reserve Bank of New York--customarily Mr. Hayes, its President, or Mr. Coombs, its Vice President in charge of the Foreign Department, who also acts as Special Manager for System foreign-exchange operations.

Recently, the work of the BIS--like that of Working Party 3 of the OECD--has been integrated with that of the Group of Ten, since the Ministers of the Group of Ten have asked the BIS to combine statistical data "bearing on the means utilized to finance surpluses or deficits" in the international accounts of the members of the Group, and to supply them "confidentially to all participants and to Working Party 3 of OECD."<sup>3/</sup>

The Federal Reserve is closely associated with, and provides technical and financial support to, CEMLA, which is a research organization established by the central banks of the Western Hemisphere. Again, our participation is mainly informational but we are also assisting CEMLA in the important task of helping to train central bankers for Latin American countries.

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<sup>3/</sup> Annex to Ministerial Statement, section 37.

In addition, the heads of the central banks of the Americas are now meeting annually for the purpose of discussing common problems. Participation of the Federal Reserve in these gatherings demonstrates that the United States is interested in close financial collaboration with its American sister republics just as it is interested in co-operating with countries in the Group of Ten.

The day-to-day activities of the Federal Reserve have been most directly affected by its participation in foreign-exchange operations. Between the early 'thirties and the early 'sixties, the Federal Reserve did not operate in the foreign-exchange market for its own account, although it continued to do so as fiscal agent for the Treasury and its Stabilization Fund, and as banking correspondent of foreign central banks. After lengthy deliberation and full consultation with the Treasury, the Federal Reserve decided in February 1962 to re-enter the foreign-exchange field. As set forth in the Authorization given by the Federal Open Market Committee to the Federal Reserve Bank of New York, the basic purposes of the operations are (1) to help safeguard the value of the dollar in international exchange markets; (2) to aid in making the international payments system more effective; (3) to further monetary cooperation with foreign central banks and the IMF; (4) to help moderate temporary imbalances in international payments; and (5) in the long run, to make possible growth in international liquidity in accordance with the needs of an expanding world economy.

The Federal Reserve has conducted its foreign-exchange operations mainly in the form of mutual arrangements with major foreign central banks and the BIS. It also purchases or sells convertible foreign currencies outright, in the spot market, or engages in forward operations in such currencies; but the total amount of spot currencies the Special Manager is authorized to hold for System account and the total amount of forward transactions as well as the purposes for which he is permitted to engage in such transactions are strictly circumscribed in the directives given him by the FOMC. Holdings of foreign currencies through outright spot purchases are limited to an aggregate of \$150 million, and forward transactions--excepting forward transactions that are merely designed to eliminate the exchange risk of spot holdings or forward commitments--are limited to \$275 million equivalent.

In contrast to the modest amounts of these market transactions, the Federal Reserve has concluded with eleven foreign central banks and the BIS mutual currency agreements, the so-called swap agreements, under which the Federal Reserve could draw a total of \$2.8 billion in foreign exchange, and its partners a corresponding amount in dollars. Generally, these agreements are on a stand-by basis; in other words, a participating central bank draws on the arrangement only when, and to the extent that, it needs an amount in foreign exchange or dollars, respectively.

Cumulatively, from the beginning of the operations to the end of July 1965, drawings under the swap agreements reached the impressive totals of \$2.2 billion equivalent drawn by the Federal Reserve and \$3.4

billion drawn by foreign central banks. Of course the amounts outstanding at any one time have been much smaller. At the end of 1964, for instance, outstanding drawings by the System totalled less than \$300 million, and outstanding drawings by foreign central banks \$200 million, leaving a net debtor position of the System of less than \$100 million--which, incidentally, has since turned into a net creditor position.

Under the swap agreements, both the System and its partners make drawings only for the purpose of counteracting the effects on exchange markets and reserve positions of temporary or transitional fluctuations in payments flows. About half of the drawings ever made by the System, and most of the drawings made by foreign central banks, have been repaid within three months; nearly 90 per cent of the recent drawings made by the System and 100 per cent of the drawings made by foreign central banks have been repaid within six months.

In any event, no drawing is permitted to remain outstanding for more than twelve months. This policy ensures that drawings will be made, either by the System or by a foreign central bank, only for temporary purposes and not for the purpose of financing a persistent payments deficit.

In all swap arrangements both parties are fully protected from the danger of exchange-rate fluctuations. If a foreign central bank draws dollars, its obligation to repay dollars would not be altered if in the meantime its currency were devalued. Moreover, the drawings are exchanges of currencies rather than credits. For instance, if, say, the National Bank of Belgium draws dollars, the System receives the equivalent

in Belgian francs; and since the National Bank of Belgium has to make repayment in dollars, the System is at all times protected from any possibility of loss. Obviously, the same protection is given to foreign central banks whenever the System draws a foreign currency.

The interest rates for drawings are identical for both parties. Hence, until one party disburses the currency drawn, there is no net interest burden for either party. Amounts drawn and actually disbursed incur an interest cost, needless to say; the interest charge is generally close to the U.S. Treasury bill rate.

The advantages of these arrangements for the United States, and for the free world in general, can best be explained by briefly discussing two instances: Federal Reserve actions on the tragic day of President Kennedy's assassination, and at the time of the sterling crisis last November.

The initial shock of the news of the assassination of the President temporarily paralyzed the New York exchange market, and there was imminent danger of panic selling of dollars here and abroad. The Special Manager of the System foreign-exchange account immediately offered in the market sizable amounts of foreign currencies at the rates prevailing before the tragedy. As the market realized that the Federal Reserve, with the cooperation of foreign central banks, was fully prepared to defend existing exchange-rate levels, speculation subsided. By the end of the day, Federal Reserve intervention plus a parallel intervention of the Bank of Canada together totalled less than \$50 million in all

currencies. No further Federal Reserve intervention was needed on the following days.

In November 1964, sterling was hit by large waves of selling, despite actions taken by the British authorities, including an increase in Bank Rate to 7 per cent and the introduction of a 15 per cent import surcharge. On November 24, a massive credit package to back up sterling began to take shape. The Federal Open Market Committee approved a \$250 million increase in the swap arrangement with the Bank of England; simultaneously, the Export-Import Bank granted Britain a \$250 million credit. The Bank of England and Federal Reserve officials were in almost continuous telephone communication with the other major central banks which participate in the network of swap arrangements with the System, and on the afternoon of November 25 a \$3 billion package of credits obtained from eleven countries and the BIS could be announced.

Federal Reserve drawings under the swap arrangements do not necessarily reflect an international payments deficit of the United States. Regardless of our overall payments position, it is unavoidable that from time to time the United States has a substantial deficit in relation to one country, and a substantial surplus in relation to another. If the foreign surplus country traditionally converts dollar accruals into gold while the foreign deficit country holds most of its reserves in dollars, the U.S. gold stock will be reduced even in the absence of an overall payments deficit; this actually happened last quarter, when--as you know--the United States had a payments surplus.

But insofar as the deficit in relation to the foreign surplus country might be deemed temporary, the decline in the U.S. gold stock could be avoided by means of a drawing on the swap arrangement with that country. Similarly, if the foreign deficit country is pressed for reserves, it may also prefer to make a drawing on its swap arrangement rather than reduce its reserves, provided that its deficit is considered temporary and reversible. Hence, swap drawings initiated by the System on some central bank are usually outstanding side by side with swap drawings initiated by some other central bank.

The concern of the Federal Reserve with international matters is not restricted to the international activities of the System. Our concern is most directly connected with the main purpose of our monetary policy: in view of the inter-relations between our country's domestic and international monetary equilibrium, domestic policy considerations are sufficient reason for avoiding policies that would perpetuate or aggravate a payments imbalance.

It is true that the recent U.S. payments deficit has been of a character very different from that of payments difficulties of most other countries. In general, a country suffers from a payments deficit when its imports of goods and services exceed its exports. But the United States does not spend more abroad on goods and services than it earns. On the contrary, it has had record export surpluses in recent years, even after deducting all Government expenditures abroad from its export receipts. But U.S. investors have lent and invested funds overseas that were larger than the export surplus. Hence, although the international

wealth of the United States has increased, its international liquidity has declined: its gold reserves have dropped, and its short-term liabilities have increased faster than its liquid claims on foreigners.

This difference between the U.S. position and the usual position of a deficit country may be important from the point of view of needed remedies; it does not alter the fact that a large and persistent decline in the international liquidity of the United States can no more be permitted to go on unchecked than could a trade deficit. There are, in my judgment, three main reasons why a continuation of the decline in our international liquidity would be extremely harmful for both the United States and the rest of the free world.

First, a large part of the free world's trade and finance is conducted in U.S. dollars. But the dollar can continue in its international role only as long as the world has full confidence in its stable value. And while the value of the dollar is ultimately based on the prosperity and stability of the U.S. economy, confidence also is deeply affected by changes in the relationship between our gold reserves and our net short-term liabilities to foreigners, especially foreign monetary authorities, which we are prepared to redeem in gold on demand. Hence, a persistent and large deterioration in that relationship--in other words, a persistent and large decline in our international liquidity--tends to undermine confidence in the dollar, and to threaten the vital role of the dollar in international commerce.

More concretely, some foreign observers have contended that the United States could have a persistent deficit in its payments only because



it could rely on the international role of the dollar. Foreign merchants, bankers, and investors have been willing to accumulate dollar balances, and foreign central banks have been willing to accumulate dollar reserves only because the dollar has been generally acceptable in settlement of international transactions. Otherwise, the United States would have had to settle all payments deficits in gold, and would have had to take drastic action long ago to keep its gold stock from being depleted.

There is only a short way from this line of argument to the demand that in the future the United States be made to abide by international payments discipline in exactly the same way as a country whose currency does not circulate internationally; in other words, that all settlements of international payments deficits be made exclusively in gold, and that the dollar cease to function as a reserve currency, if not also as a key currency in private international transactions. Such a change would not only wipe out U.S. gold reserves, as foreigners would convert their dollar balances into gold. It would also greatly reduce the international liquidity of the free world as a whole, and hence pose a serious threat to any further expansion of international commerce, or even to the maintenance of its present volume.

Second, indefinite continuation of a payments deficit would increasingly impede the conduct of U.S. monetary policy. In the long run, domestic and international goals of monetary policy are, in my judgment, identical; but in an emergency situation circumstances could arise in which a sudden elimination of a payments deficit would require monetary

measures of such severity that they would not be appropriate from the point of view of domestic policy goals. The longer the payments deficit remains unchecked, the greater the possibility or even probability of a sudden emergency of that kind.

Third, while the present international payments system has, in my judgment, functioned extremely well, it is--like all human institutions--in need of further improvement. The United States has the greatest interest not only in bringing about that improvement but also in seeing to it that the necessary improvement does not impair the international function of the U.S. dollar. But as long as our payments balance continues in deficit, all suggestions made by U.S. representatives will be subject to a suspicion that they aim not at improving the system but at finding new and painless ways to finance the U.S. deficit and thus to permit the United States to continue to run a deficit. This suspicion, unfounded though it is, needs to be allayed if we are to attain consensus on the problem of international payments reform; it will not be finally allayed until our payments position returns to lasting equilibrium.

The Federal Reserve is contributing to the elimination of the payments deficit primarily by a monetary policy designed to provide member banks with reserves large enough to permit them to continue to finance our present prosperity and to attain even better utilization of our manpower and capital resources but not so large as to permit either domestic inflationary pressures to develop or an excessive amount of funds to flow abroad. In accordance with the President's balance of payments message of February 10, 1965, this general policy is being supplemented by the

participation of the Federal Reserve in the voluntary efforts of commercial banks and other financial institutions to restrain the expansion of credits to foreigners. As you know, these efforts have been successful almost beyond expectation; but they clearly are a temporary remedy, and cannot be relied upon to bring about lasting equilibrium.

The Federal Reserve will continue to do its part not only in the attempts at eliminating our payments deficit for good but also in the work that will lead, I hope, to a better international monetary system. Such a system will, in my judgment, need to be based on existing institutions which have provided a framework for unprecedented economic progress at home and abroad: on expanded functions of the International Monetary Fund; on financial cooperation of the sort pioneered through our swap arrangements; and on the continued use of reserve currencies as a means of settling international transactions and as international reserves side by side with gold.

Whatever the differing attitudes of countries regarding the composition of their reserves between gold and foreign exchange, it is a fact of financial life that all countries use reserve currencies--especially the dollar--in their exchange markets. Thus countries in balance of payments surplus inevitably find their dollar balances increasing; the monetary authorities of countries in deficit must sell dollars in their exchange markets to support their exchange rates. This almost universal use of dollars by monetary authorities is a reflection of the widespread employment of the dollar by private traders and financial

institutions, even in transactions that do not involve the United States. The use of the dollar as a reserve is closely related to its function as a medium of exchange, and reflects as well the predominant position of the U.S. economy and the ready convertibility of dollars into gold at the established price of \$35 per ounce. Certainly any proposal for changing the international monetary system must respect these functions performed by dollars and must avoid the introduction of incentives to convert dollar holdings into gold.

Whether other countries do or do not wish to continue to use the dollar as a reserve currency is of course up to them. The United States does not insist that other nations accumulate dollars to meet their reserve needs. Nor does the United States claim that the amount of dollars that flow abroad as a result of our balance of payments position necessarily or automatically corresponds to the needs of the rest of the world for currency reserves. In this connection we at the Federal Reserve can well understand those who say in effect that international money will not manage itself.

The international monetary system must be flexible rather than rigid. It must be adaptable to the differing and, over time, changing needs of the various countries. It would be a great mistake to act as if all countries were alike in their size, structures, policies, and values. Any change in the monetary system must recognize the great diversity that exists among countries, even among the major industrial countries. And any such change must be an evolutionary one, preserving and building upon the valuable elements of the existing system.

If international agreement can be reached on such a basis, the reform of our international monetary system may be expected to contribute to world prosperity without disturbing market processes, without violating national monetary sovereignty, and without disrupting international co-operation.