

For release on delivery

Statement by

Wm. McC. Martin, Jr., Chairman,
Board of Governors of the Federal Reserve System
to the Joint Economic Committee

December 13, 1965

Mr. Chairman:

In making this response to your request for a further report on the recent Federal Reserve actions, I should like to begin by taking up the points raised in your press release announcing today's hearing.

Your first point relates to the nature of the Board's actions, and suggests that the actions represent "a most important shift" in monetary policy. In my judgment, the actions simply extend the policy that the Federal Reserve has been following of permitting money and credit to expand enough to satisfy the needs of our growing economy but not so much as to threaten inflationary disturbances. Until recently, this policy was executed primarily through open market operations, which brought about a reduction in the free reserve position of member banks from a moderate plus at the end of last year to a moderate minus. Now--as happened twice before in the course of the present economic upswing--these open market operations have been supplemented by increases in the discount rate and the maximum rate that member banks may pay on time deposits. These actions implement our policy further; they do not change it.

Your second point relates to the factors that entered into the Board's decision. These factors include the rapid improvement in output and employment; persistence of the deficit in international payments; the upcreep in prices; a build-up in credit demands due to rising Government expenditures over the

rest of this fiscal year and to a considerably faster pace of expansion in business investment during this same period; a declining trend in liquidity of both banks and nonfinancial corporations; and an increasing difficulty encountered by banks in expanding their lending capacity at then existing time deposit rates.

Your third point relates to the effect of the actions on the economy. In my judgment, this effect will be beneficial. The actions should help to sustain progress in raising output and employment by averting monetary overstimulation of the economy. They should moderate the rate of expansion in the demands for credit and at the same time enable the banks--and especially the smaller banks--to attract deposits to help meet those demands. These favorable consequences should more than outweigh any additional costs of Treasury borrowing and the increased costs of credit to business. In fact, in the longer run, the resulting increase in these costs of borrowing would be very much smaller than would be the rise in both borrowing and operating expenses that inflation would cause.

Finally, you ask whether there was appropriate coordination with the President. I can assure you that the Administration has been kept continuously informed of the position of the Federal Reserve System and that there has been a continuing frank exchange of views between the Federal Reserve and Administration officials, both before and after

the Board's actions. The Administration and the Federal Reserve are equally dedicated to doing everything possible to assure the most rapid growth of our economy compatible with reasonable stability of prices and reasonable equilibrium in our international payments. The Administration has indicated by its actions as well as by its pronouncements that it considers price inflation and a persistent payments deficit to be serious dangers to continued domestic prosperity. The actions of the Federal Reserve will help to avert these dangers and thereby will assist in achieving maximum employment, production, and purchasing power.

I should like now to discuss in more detail the factors that entered into the Board's decision, and the prospective effects of the actions upon the economy.

Over the past year, industrial production has increased 7 per cent, employment 4 per cent, and personal income more than 7 per cent. For the first time since 1957, we can expect to see unemployment reduced to or below 4 per cent of the labor force. The gains in recent years have been facilitated, and indeed made possible, by the absence of inflationary expectations on the part of both labor and management. If labor had had reason to fear a persistent substantial rise in the cost of living, it would have felt compelled to seek compensatory increases in wages; and if management had had reason to expect a general increase in the price level, it would not have felt compelled to resist such

demands. In that case, wages would certainly have risen faster than productivity; prices would have been raised in consequence; and the feared inflationary spiral would have become actuality.

Our persistent deficit in international payments has been greatly reduced but not eliminated. In fact, the deficit this year will probably be about midway between last year's level and full equilibrium. And even this limited success has been achieved only by means of serious restraints upon the outflow of U.S. capital to foreign developed countries, in the form of a broadened interest equalization tax and of a voluntary foreign credit restraint effort by banks, other financial institutions, and nonfinancial corporations. The cutback in bank credits to foreigners so far this year has been larger than the entire expected improvement in our balance of payments from 1964 to 1965. While the voluntary restraint effort, together with the interest equalization tax, probably did not account for the entire change in the flows of bank credit, it presumably played a crucial role. Hence, the restraints on capital flows, which are generally considered to be only temporary stopgaps, have been responsible for a large part if not for the whole of the improvement in our payments balance. We certainly will need to do better than that in order to assure lasting payments equilibrium.

In the field of prices we have done less well. The cost of living and the wholesale price index have both risen

faster than in any other year since 1958. And the crucial index of industrial commodity prices has begun to rise, after four years of virtual stability. It is true that prices have not broken out of the pattern of modest and selective advance in recent months. In order to avert such an eventuality, the Government has taken action relating to prices of a number of individual key commodities. But selective intervention to deal with price pressures necessarily has limits. In the longer run, it would be ineffective if not accompanied by measures that affect the source of price pressures rather than the prices themselves.

Recent developments in the financial sector of the economy have indicated some developing threat of imbalance even more clearly than have the persistence of our payments deficit and the movement in commodity prices.

In October and November of this year, bank loans to business rose at an annual rate of 11 per cent--substantially more rapid than the increase in business activity. It is true that this rate was much lower than that of the unusually fast increase in the first half of the year; but in the first half, credit demand was stimulated by the rapid build-up of inventories in expectation of a steel strike, while in recent months steel inventories have been liquidated. This liquidation is expected soon to come to an end, and once accumulation starts again, we can expect a substantial increase in business loan demands, over and above the present high level.

In order to accommodate the loan demand, banks have attempted to increase their lending resources in two ways: by adding to their time deposit liabilities, and by shifting their assets from securities into loans. But efforts to attract additional time deposits were hampered by the existing ceiling on time deposit interest rates. Offering rates of prime banks for certificates of deposit were at or near the ceiling, thus leaving smaller banks no leeway for offering the premium necessary to induce corporations to entrust their funds to a less well-known institution. Partly in consequence, the growth of negotiable deposit certificates has slowed in recent months to a small fraction of the rate prevailing during the first eight months of the year.

Over the year, banks have been obliged to finance some part of their new loans to business by reducing their holdings of U.S. Government securities and by slowing down their acquisition of securities of local governments. In the last two months, the annual growth rate for bank holdings of securities of municipalities and Government agencies was 8 per cent, as compared with 17 per cent in the first three quarters of the year. Since local governments depend heavily on bank financing, this decline threatened to jeopardize the increase in capital outlays of States and municipalities for schools, hospitals, roads, and other installations needed to provide our rising population with facilities commensurate with our rising standard of living.

The decline in bank holdings of Government securities was particularly serious because at the same time the liquidity of nonfinancial corporations--and therefore their ability to increase their holdings of such securities--was being reduced. The market's reception of the Treasury's refunding offerings in mid-November was indicative of the difficulties the Treasury was encountering in distributing its securities to investors.

All these factors brought upward pressure to bear on interest rates. And these pressures increased although the Federal Reserve kept the net borrowed reserve position of member banks roughly stable after the spring of 1965, adding about \$2-1/2 billion of Government securities to its portfolio in the process.

In recent weeks, two further developments made it evident that pressures on real and financial resources would intensify.

First, business plans to spend for plant and equipment projected a considerably faster pace of expansion than was previously considered likely. The results of the Government survey, just released, document that business outlays are scheduled to rise at an annual rate of 15 per cent, at least throughout the first half of next year. Of late, actual spending typically has exceeded the estimates based on the surveys.

Second, the course of the war in Viet Nam made certain a step-up in the rate of Government expenditures. In consequence, Federal needs for funds over the next few months will be significantly heavier than expected only a few months ago.

Both these developments are adding to the pressures on financial markets. In this environment, the only way by which the Federal Reserve could have averted a further rise in interest rates would have been to accelerate sharply its provision of reserves to the banking system. This would have been a serious departure from the course the Federal Reserve has been following, which was designed to keep the rise in bank credit and money from becoming excessive. In my judgment, the course of moderation the Federal Reserve has been following has helped to provide the financial basis for the satisfactory development of our economy this year.

Reflecting the intensity of credit demands, however, interest rates in money markets had risen above the discount rate. This relation could not be permitted to last indefinitely because it could stimulate an excessive resort by banks to borrowing from the Federal Reserve.

Demand pressures have not been confined to money markets. The issue of corporate securities also has greatly expanded, and is expected to expand further. Internal funds, and especially undivided profits, of manufacturing corporations have been rising more slowly than their investments in plant, equipment, and inventory. The rising need for external financing has made it necessary for corporations to increase both their borrowing from banks and their recourse to capital markets.

All these considerations justify, in my judgment, not only the substance of the Board's actions but also their timing. At present, we can expect a modest rise in interest rates to restore equilibrium between the flow of savings and credit demands. Delaying action further would probably have made it necessary to take stronger measures later.

Let me stress once more, in conclusion, that the recent actions of the Board have been, in my judgment, a further unfolding of a policy designed to keep the expansion of credit in line with the needs of the economy, avoiding both inflationary and deflationary disturbances.

If the Federal Reserve had followed the advice offered by some and had tried to force interest rates up at a time when the demand for investible funds (even at relatively low rates) was not sufficient to employ our idle resources and to move our economy vigorously towards fuller employment, such a policy would indeed have harmed our domestic economy, and in consequence the economy of the entire free world. Conversely, if the Federal Reserve had strained to keep interest rates from rising by providing reserves without limit at a time when funds borrowed from banks were beginning to generate an aggregate demand in excess of output from available resources, the result would clearly have been inflation.

The Federal Reserve will continue to shape its policies with flexibility, firming or easing as may be necessary to help the economy move forward at the fastest sustainable pace.

Summary Statement
of
Wm. McC. Martin, Jr., Chairman,
Board of Governors of the Federal Reserve System
to the Joint Economic Committee
December 13, 1965

I am glad to appear before your Committee to make this further report on the recent Federal Reserve actions raising the maximum rate payable by member banks on time deposits and the discount rate member banks pay on their borrowings from the Federal Reserve Banks.

I understand that you have asked that witnesses this morning confine their remarks to brief summaries of their views. In making this brief statement, I speak for the majority of the Board of Governors. With your permission, Mr. Chairman, I would like to offer for inclusion in the record of these hearings a copy of the Board's press release announcing these actions.

The Federal Reserve acted because it believed that the previous level of the discount rate and of time deposit rates was out of line with conditions in the money and credit markets and especially with the need to keep the flow of bank credit large enough to satisfy the needs of our expanding economy but not so large as to threaten to turn that expansion into an inflationary boom.

The actions were taken not to hamper but to further the goal of the Administration--shared by the American people as a whole--to do the best that can be done to assure the continuance of our economic expansion, maintenance of generally

stable prices, and restoration of reasonable equilibrium in our international payments.

As we have sought to make clear from the outset, the recent increase in rates is intended not to reduce the pace of our upswing but to moderate mounting demands for bank credit that might jeopardize that pace by overstimulating the economy.

Throughout 1965, the Federal Reserve System has followed a policy that permitted member bank reserves to grow in response to the credit needs of a growing economy. It became increasingly apparent, however, that the rate at which we were supplying reserves to the banking system, even though it supported a strong rise in the money supply and in bank credit, was not enough to meet the intense demand for credit at prevailing interest rates. In response to this demand, interest rates rose in most financial markets. As a result, money market rates rose above the discount rate, and time deposit rates pushed against the established ceilings, hampering the efforts of banks to tap available funds to meet the mounting demand for credit.

The Federal Reserve faced a choice between (1) attempting to check or reverse the rise in interest rates, by accelerating the rate at which it was providing reserves to the banking system, or (2) raising the time deposit rate ceiling to allow the economy to use more efficiently the funds already available and raising the discount rate to bring it more in line with market rates. We chose the latter course, because we believed the former course posed too great a risk to the economy.

A brief review of developments over the past 12 months in production and employment, the balance of payments, and prices will provide background for this assessment of the potential effect of our actions on the economy.

The production and employment record of our economy has been excellent. Our industrial output will be at least 7 per cent higher this year than in 1964. For the first time since 1957 it seems likely that we may soon reach our interim goal of pushing unemployment down to, if not below, 4 per cent of our labor force. And despite such progress, labor costs per unit of output in manufacturing remained virtually unchanged until recently, when they moved up somewhat.

Our record on international payments balance is fair, but less satisfactory than in the field of production and employment. Over the first three quarters of the year, our deficit on so-called "regular transactions" was at an annual rate of one and three quarter billion dollars--smaller than in any calendar year since 1957 but still too large for comfort.

But in another critical area, maintenance of general price stability, our record has not been so good as in other recent years. In the summer of 1964, the index of industrial wholesale prices began to rise after four years of virtual stability, and has since risen 1.7 per cent. Consumer prices have risen 1.8 per cent in the past year--again, a somewhat faster rate than prevailed earlier.

It is quite true that prices have not broken out of the pattern of modest and selective advance in recent months. In order to avert such an eventuality, the Government has taken action relating to prices of a number of individual key commodities. But selective intervention to deal with price pressures necessarily has limits. In the longer run, it would be ineffective if not accompanied by measures that affect the source of price pressures rather than the prices themselves. The closer an economy comes to full employment of manpower and capital resources, the greater is the risk that bottlenecks will develop in strategic areas so that large new injections of bank credit and money would serve to raise prices more than production.

As long as unemployment of manpower and plant capacity was greater than could be considered acceptable or normal, we had every reason to lean on the side of monetary stimulus. While this posture did risk some spill-over of funds abroad, the adverse effect on our payments balance was more than offset by the benefit to our domestic economic growth. And we have tried to combat excessive capital outflows by selective fiscal and monetary measures, including the programs for voluntary restraint of foreign credits and investments.

But despite the splendid cooperation of the financial community, and the dramatic slowdown in foreign lending by financial institutions, foreign investments of nonfinancial corporations were large enough to explain the persistence of

our international payments deficit. As financial institutions reduced drastically the availability of new dollar credits abroad, and thus had more funds to devote to domestic uses, their domestic customers were in a position to use part of the newly available funds to finance their ventures abroad. This is an example of the leakage inherent in selective credit controls.

Our closer approach to a satisfactory level of domestic output and employment has diminished the weight of the arguments against the use of general rather than selective measures to help counter price pressures at home as well as to help correct our payments imbalance. Obviously, no one, and least of all those of us responsible for monetary policy, would ever want to do anything that could undercut the sustained progress of the economy. But those who are fearful of the economic consequences of any move even towards the mildest restraint--any drop of free reserves below zero, any slight rise in interest rates--would do well to consider the record of the economy's performance over the past 12 months.

Let none of us overlook the fundamental difference between a change in interest rates imposed by a central bank contrary to the trend of basic economic forces, and a change permitted by the central bank in line with those forces.

If the Federal Reserve had followed the advice offered by some and had tried to force interest rates up at a time when the demand for investible funds (even at relatively low rates)

was not sufficient to employ our idle resources and to move our economy vigorously towards fuller employment, such a policy would indeed have harmed our domestic economy, and in consequence the economy of the entire free world. Conversely, if the Federal Reserve had strained to keep interest rates from rising by providing reserves without limit at a time when funds borrowed from banks were beginning to generate an aggregate demand in excess of output from available resources, the result would clearly have been inflation.

We believe that we have managed to steer a constructive middle course between these two policy extremes, providing a beneficial degree of monetary stimulus when the economy was slack and then gradually moderating this stimulus as the expansion gained strength and demands began to press harder upon available resources. The Federal Reserve will continue to shape its policies with flexibility, firming or easing as may be necessary to help the economy move forward at the fastest sustainable pace.