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Statement by

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Monetary policy is unique among the economic tools available to Government in the promptness and flexibility with which it can be adapted to changing economic circumstances. This capacity for prompt, flexible adaptation has been essential over the past year and a half--and it has been amply demonstrated. Within this short period, monetary policy had first to play a major role in moderating an excessively rapid expansion that was generating strong upward price pressures. And when--within the year--the pace of expansion was brought into better balance with the growth in resources, financial restraint was relaxed and policy turned promptly toward encouraging increased flows of money and credit.

The timing of changes in policy, as well as the degree to which policies of restraint or ease may be carried, are necessarily matters of judgment. There is still much to be learned about economic stabilization policies, both fiscal and monetary, in a high employment environment.

Nevertheless, the difficulties encountered should not be allowed to obscure the rapid and favorable response of the economy to changes in the direction of monetary policy. For example, since indications of abating inflationary pressures last fall made it possible for monetary policy to be redirected toward ease, interest rates have come down swiftly, with some rates already below their

levels of a year ago; bank credit has expanded at a vigorous rate; inflows of savings to thrift institutions have picked up very substantially; the housing outlook has brightened considerably; and resumption of more orderly and balanced economic growth is in prospect. The experience of the past year and a half should serve as a warning against underestimating the resilience or responsiveness of the U. S. economy.

Nor should we overlook the substantial gains recorded by the economy last year, despite our valid concerns for those sectors of the economy that did not share fully in the advance. 1966 was a year of considerable economic achievement. Our gross national product rose by 5-1/2 per cent in real terms, well above the long-term growth trend. More than 3 million workers were added to the nation's payrolls, and the capacity of our factories grew by almost 7 per cent. Moreover, for the first time in over a decade, the United States was able to achieve substantially full utilization of its growing resources. Unemployment fell below 4 per cent, the lowest level since 1953. And unutilized industrial capacity declined to the lowest level since 1955. This was an impressive performance, one in which we all can take some pride.

But the record was not unblemished. Indeed, in pushing forward under forced draft, some serious strains and distortions emerged in the structure of production, finance, and our balance of payments--flaws, which if not corrected, could seriously hamper our ability to sustain rapid economic progress. Let me touch on the most important of these, for there are lessons to be learned by policy makers in all branches of Government from the failures as well as the successes of economic policy.

First, as we approached full utilization of resources, demand pressures manifested themselves in a strong and pervasive rise in costs and prices. In an economy where many wage contracts are geared to cost-of-living changes, yesterday's price increases become tomorrow's cost pressures. It may prove difficult to avoid, in 1967, some reflection in costs and prices of the failure to restrain adequately the inflationary pressures of 1966.

Second, the excessively rapid pace at which domestic demands grew meant that they could not be satisfied from domestic sources alone. Our imports of materials and finished goods-- particularly capital goods--surged. And although U. S. exports continued to rise somewhat faster than their long-term uptrend, our favorable net balance on international trade was seriously reduced-- by almost one-fourth.

Third, rapidly rising demands by Government for defense needs and by business for capital investment programs pre-empted a large share of our physical and financial resources. Home-building was elbowed to the rear of the queue; residential construction activity was reduced far below the levels needed to meet our long-term housing needs.

No country can long sustain economic progress if wages and prices keep leap-frogging each other, if it continues to lose ground in international commerce, or if it permits serious imbalance in the composition of output. The task of stabilization policy last year was to strike at the root cause of these distortions and imbalances--an over-rapid pace of expansion of aggregate demand.

The need for moderating expansion became evident even before 1966 began, as acceleration in defense outlays was added to the stimulus to private spending provided by earlier monetary expansion and the tax reductions of 1964 and early 1965. In the final months of 1965, economic activity spurted--but so did prices. The rate of increase in the GNP deflator--which measures the extent to which the dollar growth in GNP is a result of rising prices rather than rising output--doubled in the fourth quarter of 1965.

Moreover, increasing evidence was becoming available to suggest that demand pressures would intensify further. Restraint was needed and needed promptly. As the current Report of the President's Economic Advisers puts it, "All in all, the economy exceeded reasonable speed limits in the period from mid-1965 through the first quarter of 1966."

In response to intensification of inflationary pressures, Federal Reserve policy moved toward greater restraint. This was signalled by the announcement in December of an increase in the discount rate from 4 to 4-1/2 per cent. To prevent an abrupt constriction in the flow of credit, the maximum rate banks could pay for time deposits was raised, and reserves were provided generously through open market operations over the subsequent year-end period, weeks usually marked by turbulence and cross-currents in financial markets.

Net reserve availability was reduced gradually in early 1966, and increasingly, banks were forced to turn to the discount window to obtain additional reserves. Their borrowings from the Federal Reserve rose from an average of about \$400 million in January to about \$700 million by June.

At certain critical times, however, such as around the March-April tax period and again around the mid-year tax period, nonborrowed reserves were supplied to banks in substantial volume to help moderate the temporary but intense money market pressures being generated by enlarged corporate needs for funds to meet accelerated tax payments. With business loan demands strong, failure to provide additional reserves to banks at these times would have prompted more rapid liquidation of bank holdings of securities; the consequent rise in interest rates would have accelerated the outflow of funds from thrift institutions to financial markets. It would also have prompted even more widespread and aggressive efforts by banks to attract consumer savings into time deposits. Such efforts would have intensified the developing shortage of mortgage money at a time when financial supervisory agencies lacked the flexible authority--granted by Congress later in the year--to limit excessive competition for savings funds.

Nevertheless, in the absence of greater fiscal restraint, the basic economic situation continued to oblige the Federal Reserve to maintain an over-all posture of monetary restraint. Prices were continuing to rise rapidly; in the second quarter of the year, the GNP price deflator increased at over a 4 per cent annual rate. Successive surveys of business plans for capital spending indicated that the

exceptionally strong advance in business capital outlays was likely to continue. Pressures on financial markets mounted as businesses sought credit at banks and in capital markets to finance current needs and prospective capital spending programs, and enlargement of the Federal Government's financing requirements added to these pressures.

To limit expansion of bank credit and moderate bank competition for savings, the Federal Reserve raised reserve requirements against time deposits in June and again in August, and reduced the maximum rates banks could pay on certain maturities of time deposits. Commercial banks found it increasingly difficult to compete effectively for large blocks of corporate liquid funds, as market rates on competitive instruments rose to--and subsequently above--the ceiling rates on large denomination certificates of deposit.

Some banks with branches abroad were able to compensate, in part, for reduced availability of domestic sources of loanable funds by borrowing through their branches in the Euro-dollar market. This absorbed dollars that might otherwise have flowed to foreign monetary authorities, and as a result, the U. S. balance of payments on an official settlements basis moved into substantial--though temporary--surplus in summer.

But not many banks had direct access to foreign sources of funds. The Federal Reserve's general policy of restraint on domestic credit expansion, as well as its specific attempts to diffuse the impact of restraint, were evidenced in a declining share of total credit flows passing through commercial banks. By the third quarter of 1966, commercial banks were able to supply only 7 per cent of the funds raised by consumers, corporations, and governments, down from about 25 per cent of the total in the first half of the year, and over 40 per cent of the total in all of 1965.

Viewing credit flows in broader perspective, all financial intermediaries--banks as well as thrift institutions--were falling behind in the competition for savings flows; investors preferred the higher yields available through direct investment in market securities. Consumers as a group, for example, allocated over one-fourth of their net financial savings flows last year to direct purchases of securities, compared with the less than 3 per cent invested directly, on average, from 1961 to 1965. Corporations, too, diverted funds to market instruments, and drew down their holdings of negotiable certificates of deposit and other cash assets as external financing became more costly and less easily obtainable.

The diversion of savings flows away from financial intermediaries severely limited the availability of funds to those borrowers most dependent on institutional sources of financing. Particularly affected were builders and home buyers, since ordinarily the great bulk of the financing of construction and purchase of homes in the United States is supplied through financial institutions.

Institutions specializing in mortgage finance, by and large, did not possess the financial resources or flexibility to cope with large and sudden shifts in savings flows and still maintain a flow of commitments and funds into the housing industry. The bulk of the liabilities of savings and loan associations and mutual savings banks are payable on short notice, while the bulk of their assets are of fixed yield, and turn over slowly. These institutions have been relatively slow in developing a structure of liabilities which would permit them to offer higher returns in order to immobilize, for fixed periods, the most highly interest-sensitive funds. Moreover, only a limited volume of loanable funds could be obtained from liquidating assets or borrowing from the Federal Home Loan Banks to supplement diminished savings inflows.

Rigidities in our financial system, therefore, helped focus on home builders and home buyers much of the initial impact of the financial restraint needed to curb inflationary credit flows. But as

the year progressed, flows of credit to other borrowing sectors became more limited. State and local government borrowing began to be curtailed as large commercial banks, previously very active buyers of municipal securities, reduced their purchases to husband available funds. Consumer credit lenders, finding funds more expensive to acquire, began screening out some marginal borrowers. Credit extended to foreign borrowers by American lending institutions was sharply curtailed, even below the limits established in the voluntary foreign credit restraint program. Even domestic business firms, which previously had been most successful in increasing their external financing, were experiencing constraints on their borrowing ability, particularly at banks.

In addition to the earlier Board actions aimed at limiting the diversion of funds from the mortgage market, the Presidents of Federal Reserve Banks addressed a letter on September 1 to member banks urging moderation in business loan expansion in the interest of achieving a more balanced economic and credit expansion. The letter assured System members that banks losing deposits and adjusting their positions through curtailment of loan commitments would be able to obtain accommodation through the discount facilities of the Federal Reserve for longer periods than would be required if adjustments to deposit losses were to be accomplished through disposition

of securities. The longer-lived availability of Federal Reserve discount credit would thus permit member banks to adjust to deposit losses without adding to the pressures on construction finance or on markets for State and local government securities.

A similar kind of contingency planning had earlier been introduced with respect to nonbank thrift institutions and commercial banks not members of the Federal Reserve System. Some of these institutions have only limited access to public sources of emergency credit. Arrangements were activated, therefore, to permit Federal Reserve Banks to provide credit assistance to any such institution that might suffer sudden withdrawals that could not be met by resort to its usual sources of funds. This facility was not expected to be needed, and has never in fact been used; it represented simply an assurance that protection existed against the remote possibility of exceptional drains of funds that could not be accommodated through normal adjustment procedures.

When, in late September, Congress enacted legislation granting the Federal Reserve and other financial regulatory agencies temporary additional authority for establishing maximum rates payable on deposits and shares, the Federal Reserve acted promptly to reduce the ceiling rates commercial banks could pay on consumer-type time deposits. This was part of a coordinated effort by the

regulatory agencies to limit further escalation of interest rate competition among depository institutions for consumer saving.

A reduction in the over-all degree of monetary restraint was not possible, however, as long as the pace of aggregate economic activity continued to outstrip the growth in resources, and prices remained under strong upward pressure. Federal spending contributed to the rising pressures on the economy, as expenditures increased much more rapidly than revenues. The Federal Government's budget, on the national income accounts basis, moved from a surplus position in the spring to a deficit after mid-year. Through August, industrial production and wholesale prices continued to rise rapidly, spurred not only by the sharp acceleration in defense spending but also by continued large increases in business outlays for capital equipment and a rebound in consumer spending, particularly for durable goods.

In September, several fiscal actions were proposed by the President, and subsequently enacted by the Congress, that helped share the task of containing inflationary pressures in the economy. The suspension of the investment tax credit and accelerated depreciation provisions was directed at one of the major expansionary forces in the economy, business capital outlays. Moreover, the President's

announcement of intended reductions in lower-priority Federal expenditures indicated another area where action to moderate inflationary pressures would be taken.

The monetary and fiscal actions undertaken to convert an over-exuberant economy to one expanding at a slower but healthier rate were successful. By fall, business plans for capital spending were being tailored to a more sustainable rate, and new orders for durable goods began to level off. The rise in prices began to slow, too, principally in reflection of larger supplies of agricultural products, but also because demand pressures for some materials were subsiding.

Responding to these signs and portents of abatement in inflationary pressures, monetary policy promptly moved to relax the degree of credit restraint. By November, the provision of reserves to the banking system through open market operations began to increase, and in December, the Board announced that the special discount arrangements outlined in the September 1 letter were no longer needed. Bank credit, which had contracted over the summer and early fall, began a vigorous expansion in December that has continued through the early weeks of 1967. The expansion in bank credit in December was at a 9 per cent annual rate, and preliminary estimates put the January expansion at around 15 per cent.

Market interest rates have declined substantially from their late summer peaks. For example, yields on new prime corporate bonds have fallen by about a full percentage point, and declines in Federal, State and local bond yields range from a half to a full percentage point. At the moment, bond yields are at their lowest levels in over a year.

Even more dramatic have been the declines in some of the more sensitive short-term or money market rates, such as those on Treasury bills. In some instances, these rates have fallen by as much as 1-1/2 percentage points. For example, the 6-month Treasury bill rate has fallen from a peak of just over 6 per cent to just over 4-1/2 per cent recently. Some rates which characteristically adjust more sluggishly to changes in general credit conditions, such as mortgage yields and bank lending rates, have shown less downward movement thus far, but in varying degree, they have also turned lower.

There are encouraging signs that the economy is responding well to these changes in financial conditions, undertaking orderly corrective adjustments to last year's excesses. Over-optimistic estimates of market demands in 1966--typical of emerging inflationary expectations--had induced businesses to produce far beyond current sales requirements. As a result, inventory

accumulation was large throughout the year, and stocks began to pile up in exceptionally large volume in the final months of 1966. Efforts are currently being made to bring production into line with sales in many industries, providing a sounder basis for expansion later in the year.

Moreover, as the pace of industrial activity has slowed, imports have begun to subside. With export growth maintained, there are signs that the U. S. international trade balance is on the mend again. This is indeed a welcome development at a time when our balance on international capital flows shows signs of slipping.

Further, flows of savings to thrift institutions have resumed with vigor. The net inflow of funds to savings and loan associations showed substantial improvement in November and December, and high inflows appear to have continued in January. Similar inflow gains are being reported at mutual savings banks and in time deposits at commercial banks. It would appear that the shortage of funds for the housing industry is well on its way to being alleviated.

The task of economic policy in the period ahead is to support continued full utilization of resources, while assisting the economy in restoring the price stability and international trade trends that graced the expansion from 1961 through mid-1965. It will not be

an easy task, possibly not one we can accomplish within so short a span as a year. But with monetary policy responding flexibly to changing pressures on the economy, and with the President's tax proposals a bulwark against a repetition of surges in demands that marred the economy's performance in 1966, we can look forward with greater confidence to a better balanced expansion in 1967.