For release on delivery
(12 Noon EDST, June 26, 1967)

Summary of Remarks
by
Wm. McC. Martin, Jr., Chairman,
Board of Governors of the Federal Reserve System,
before the
Rotary Club of Toledo

Commodore Perry Hotel
Toledo, Ohio

June 26, 1967
As all of you are undoubtedly aware, the Federal Reserve System moved promptly into a policy of monetary ease last fall as soon as the inflationary forces that marred economic progress in 1966 had been brought under control. This policy of ease, pursuit of which has continued this year, has cushioned the impact on the economy of adjustment to the inflationary excesses of 1966, especially the adjustment to the excessive inventories accumulated during the period of inflationary expectation.

The System's policy of monetary ease, together with stimulative fiscal actions, particularly in the form of higher-than-expected Government expenditures, has been successful in preventing the economic adjustments from becoming cumulative. Now, after only a short pause, the economy is beginning to show signs of moving ahead again.

As a result of the System's expansionary monetary policy, the nation's money supply has increased at an annual rate of 6 per cent this year and total credit outstanding at all commercial banks has expanded at more than an 11 per cent annual rate in the same period. The liquidity of financial institutions generally has improved as has the liquidity of many corporations and of consumers generally.

In the face of such monetary ease, many persons find most puzzling recent financial market developments that have returned long-term interest rates to levels in the neighborhood of their peaks of late last summer, while short-term rates have shown substantial declines and, in some areas, are more than two full percentage points below their 1966 highs.
The explanation lies in the huge demand pressures that have been exerted on the bond market by corporations and by state and local governments trying to raise record amounts of long-term funds. Publicly offered corporate bonds, for example, amounted to approximately $6 billion in the first five months of this year in contrast to $8 billion for the whole of last year and only $5.6 billion in all of 1965.

This concentrated outpouring of new security issues is related to three basic reasons: First, many corporations found their liquidity positions reduced to uncomfortably low levels during the 1966 boom and there has been an understandable desire to rebuild their cash reserves from sources outside the banking system. Secondly, current business spending for plant and equipment has continued at exceptionally high levels requiring more cash than has been generated by internal flows. Similarly, total outlays by states and municipalities, including those for capital improvements, exceed currently available funds by a substantial margin.

Finally, and most important, market participants seem to feel that no matter how high interest rates may be pushed by their efforts to raise long-term funds now, the situation may be even worse before the end of the year. Borrowers, investors, and market professionals all are expecting a large Federal deficit in the fiscal year ahead. They fear that financing such a deficit will put additional heavy pressures on the market and that a deficit of this size, along with resurgence in private demands, harbors the potential of reviving inflationary pressures by the boost it will give to spending and to private incomes, in turn stimulating additional credit demands.
The problem of trying to change market expectations as deeply ingrained as these appear to be is difficult indeed, but change them we must if bond markets are to become less susceptible to upward rate pressures and if we are to avoid the possibility of renewed diversion of funds from mortgage markets that would seriously hamper the recovery of housing.

It is for these reasons that I am firmly convinced that we must have adequate, effective—and above all—prompt tax action that would whittle down the prospective deficit for the coming fiscal year to one of manageable proportions.

From the beginning, I have favored the President's proposal for a 6 per cent surtax. In light of the recovery under way in the economy and the current rate of Government spending, I would be prepared now to support an even higher amount, if it is warranted when appropriations by Congress for Government spending during the coming year have been completed. But we should not delay in coming to grips with the problem, for delay would permit inflationary forces to gain momentum as well as permit market expectations to become even more deeply embedded.

It goes almost without saying that I am equally in favor of holding down or cutting back Government spending wherever that is possible without impairing the efficient provision of public services the country has determined it wants to have. Ours is a great and a prosperous nation and we can undertake whatever programs we feel we need, so long as we are willing to assume the financial obligations
involved. When we fall into the habit of perpetual deficit financing the soundness of our currency and the strength of our economy will eventually be undermined.

From my experience, the American public will support any policy which they are convinced is essential in the national interest. The public recognizes that the war in Vietnam—which, after all accounts for the major share of added Government expenditures—must be paid for. I believe that a tax increase now deserves, and will receive, broad public support. I'm confident, too, that Congress will reflect this support and take the actions to provide, in appropriate measure and timing, the fiscal discipline we need to ensure sustained economic progress.

There is another proposal I should like to put before you that in my view is equally deserving of public support and adoption by the Congress. I have come to the conclusion that we should also act now to eliminate the 25 per cent gold cover requirement against Federal Reserve notes, and thus remove any uncertainty concerning the availability of our gold for official settlements with other governments.

The readiness of the U. S. Treasury to buy and sell gold at the fixed price of $35 an ounce in transactions with foreign monetary authorities has greatly contributed to the willingness of foreign monetary authorities and private foreign residents to hold dollar reserves and working balances. As a result, the dollar has attained a unique position in international commerce and finance, and the
universal acceptability of dollars has greatly facilitated the record expansion of international trade. Since 1950 world trade has tripled, rising from less than $60 billion to $180 billion last year. Thus, the availability of U. S. monetary gold holdings to meet international convertibility needs is a matter of vital importance not only to the United States but to the entire present system of international payments on which the free world relies.

Over the years ahead, the continued growth of U. S. economic activity will require continuing monetary expansion consistent with a stable dollar. Under prospective conditions, it appears all but certain that the gold certificate reserve ratio of Federal Reserve Banks, for domestic monetary purposes alone, will steadily decline, even if gold sales to foreign monetary authorities are small. Of course, any substantial further outflow of gold would accentuate the decline.

At the end of May our total gold stock amounted to $13.2 billion, of which almost $10.0 billion was earmarked as the 25 percent reserve required against Federal Reserve notes outstanding. This left "free gold" totaling $3.2 billion. The steady increase in Federal Reserve notes in circulation each year to meet the needs of a growing economy amounts to about $2 billion, thus reducing the "free gold" by about $500 million per year. Net sales of monetary gold for domestic industrial and artistic uses approximate another $150 million per year. Future purchases and sales of gold by official foreigners cannot be predicted, but so long as the United States continues to run large balance-of-payments deficits, it is reasonable to expect additional gold losses for that reason as well.
It seems inevitable then that the removal of the present gold cover requirement must come and the question becomes essentially one of timing. By acting now the Congress could erase any doubt or uncertainty due to this requirement that might affect confidence in the dollar.

There is an inescapable practical requirement that we maintain an adequate gold stock to back up the role of the dollar as a key currency in world trade. Hence the need to conserve our gold stock will continue to exert a disciplinary influence on monetary and other governmental policies.

All of us need to be mindful that sound money is not established by statute alone. In the end, our nation cannot have sound money unless its monetary and fiscal affairs are well managed. The fundamental elements in keeping our financial house in order are sound and equitable fiscal and monetary policies.