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Box 19 Heller

See re:
Eisenhower

1953 Then 1961

V-10

For the Record May 30, 1961
cc: Messrs. Heller, Gordon, Solow

James Tobin

Luncheon Conversation with Chairman William McC. Martin
on May 29, 1961

On May 29 Messrs. Heller and Tobin had lunch with Chairman Martin in his office at his invitation in order to discuss the difficulties which he said were confronting Federal Reserve in the bond market. No one was present other than these three individuals. The luncheon lasted from 1:00 p.m. until 3:30, and many topics were discussed. I will not attempt to give a report of them in chronological sequence, but I will try to cover the main points made.

1. Martin began the conversation, after the amenities, by discussing his political position and his tenure of his job as Chairman. He said that he was a registered Democrat and had voted for Stevenson in 1952. Subsequently he has been completely out of politics and has not let anyone know his political preferences. He recalled that he had been appointed to his position by Truman, and he described his attempt to resign when President Eisenhower came in in 1953. He said that he had a fine private job offered to him at that time, and he let it be known in the White House that he was quite willing to resign. However, General Clay told him to hold on for a while, and finally there was arranged an interview with Eisenhower. He expressed his willingness to resign to Eisenhower, and Eisenhower asked for time to consider the matter. Subsequently Martin was informed that the Administration and the President desired for him to continue. Martin made clear that he had told the President that he was a Democrat. In 1956 the matter did not come up.

During the Presidential campaign of 1960 there were stories beginning in Newsweek in June that the Kennedy Administration, if elected, would wish Martin to go. Also, during the campaign monetary policy was an issue, with the Democrats criticizing tight money. For these reasons Martin felt that a matter of principle was involved, and he decided that he should not offer his resignation to President Kennedy. He felt that he had an obligation to his supporters in the System and to those persons in private life who have been defending the System to remain in his position until the end of his term. This he still intends to do. For essentially the same reason he believes that the Federal Reserve and the Chairmanship should be nonpolitical and he regards the best demonstration of this principle to be for him to remain in his position until his term is over. He mentioned this because he had heard indirectly of some sentiments in the

White House that he should resign and he wanted to make it clear that he did not intend to do so. He did not associate the Council with these rumors, and he concurred with Heller's explicit disassociation of the Council from them. The Challenge article was rather obviously in the background of this discussion, but it was not mentioned explicitly on either side. Martin did not explain why he changed his mind about proper procedure for the Chairman between 1953 and 1961, and we did not ask him.

2. Martin was concerned about the growth of rumors of severe disagreement between the Council and the Federal Reserve, and he was concerned with Council statements about the monetary policy. Apparently he found these rumors extremely frequent in New York while he was there on the "desk" last week. In some way which was not very clearly defined, he believed that these rumors were disrupting the bond market; and I take it that his main message to us was to ask us to be careful about public statements for fear of the effect we might have on the market. He acknowledged that we had a perfect right to disagree with him and with the Board about monetary policy, and moreover a perfect right to express our views publicly. But he pointed out that policy is made by the Open-Market Committee and the Board, and not by us. He referred specifically to reports that Tobin had advocated a reduction in the discount rate. He regarded this as a legitimate difference of opinion, but he referred to the continuing international problem. Tobin pointed out that he had said in testimony before the Joint Economic Committee that the 3 percent discount was a deterrent to recovery, but he had recognized the need to consider the balance of payments in making monetary policy. Martin also referred to reports that the Council would like to see the bill rate go down even below 2 percent. We replied that we believed the bill rate might be permitted to fall closer to 2 percent now that international pressures had abated, but that we had not suggested that it could now go below 2 percent. Martin referred to Heller's Calvin Bullock remarks on Council-Treasury-Federal Reserve differences in emphasis within the context of general consensus on monetary policy and said that these remarks were widely quoted throughout the market. Heller showed Martin the article in the May 27th Economist and suggested that the Press and the market liked to exaggerate differences. Martin agreed to this and said that these things did not bother him, as he had long experience in Government with the Press and with rumors.

3. Martin turned to the current problem in the government bond market. He said that the Federal Reserve was now the sole buyer in the market and that many holders were willing to dump large holdings into the hands of the Fed since the market was convinced that government bond yields must rise. He said there was a real problem of maintaining

government bond prices without engaging in "pegging." He did not wish, nor did his Board, to put more money into the market than was needed to execute the established monetary policy; that is, more than was needed to maintain free reserves at $500 million. He did not believe that this quantity would be sufficient to keep bond yields from rising. He attributed the recent change in the psychology of the bond market to several factors: first, the signs of recovery; second, the rumors of advanced refunding; third, the anticipation of increased government spending and borrowing needs; and fourth, the general resumption of inflationary expectations, associated in part with the stock market boom. He contended that bank reserve positions have been kept easy, so he did not attribute the decline in the bond market to shortage of bank liquidity. He was asked whether the Fed could not purchase additional bonds and obtain the funds by selling bills in order to prevent reserves from expanding above their target. His response was partly that this would be pegging and partly that the Federal Reserve was short of bills to sell. Tobin suggested that the Federal Reserve might pursue a policy of providing enough reserves to keep the recovery from automatically tightening the money credit markets, as gauged by the short-term rate, and not worry too much about what week-to-week expectations are doing in the bond market. Martin said that in that case bond yields would surely rise, and he wanted us to be prepared for that.

4. This led into a discussion of the appropriate monetary policy during the expansion. As suggested above, the present policy of the Fed is to keep free reserves at half a billion dollars. Martin believed it would be very difficult to persuade his Committee to adopt an easier policy than this. He, himself, was certainly in favor of continuing this degree of ease, at least for the time being. Tobin said that banks should be kept supplied, by purchases of longs and intermediates, with enough reserves during the expansion so they could finance it without selling off their bills and other government securities, at least as long as we were short of full employment and inflationary pressures had not become evident. He suggested that there was less reason now to worry about expansion of bank reserves pushing the bill rates too low for our international purposes; first because the international constraint itself was relaxed, and second because the expansion would be tending to tighten bill rates, and the action of the Federal Reserve would be required to keep them from rising. Martin regarded this as too expansionary a credit policy. His interpretation of a policy of "ease" does not extend to offsetting the natural tendency of the market to tighten credit. If the market tightens credit while the Federal Reserve is following an unchanged policy with respect to reserves, Martin does not regard that as restrictive policy, but rather as a continued policy of ease. He believes that banks' loan-deposit ratios have been tending to rise dangerously and he thinks it

would be unsound to permit them to rise unchecked during an expansion. He believes that credit is like a rubber band. It can be stretched just so tight, then it inevitably snaps. It was suggested that the Federal Reserve has a lot to do with whether it snaps or not, and that what the Federal Reserve does, it can also undo. Martin regarded this as a hopelessly naive remark and point of view. He does not believe the Federal Reserve has that much power over the market and over the banks. He thinks the banks can if they want to sustain a tremendous expansion of credit without increase in reserve base.

5. There was some discussion about the appropriate level of interest rates. Tobin and Heller expressed their concern that U. S. interest rates were not only cyclically too high but secularly too high for the domestic economic position. They cited the almost unanimous concurrence of the Treasury's consulting economists in this point of view. Martin cited the fact that the U. S. interest rates were the lowest in the world among major industrial countries, and he quoted European sentiment that the U. S. interest rates should be higher for purposes of the international balance of payments equilibrium in order to relieve the pressures on Germany, for example, to have low interest rates with inflationary risks. Tobin responded that the productivity of capital, which was related to the size of the stock of capital relative to the labor force, was quite possibly lower in the U. S. because we had developed further, and that interest rates must be adjusted to this basic natural rate. There followed a discussion of the extent to which the government, including the Federal Reserve, has any control over rates. Martin was at pains to emphasize that the government does not control the demand for securities of various kinds. But he was constrained to agree that the government does control supply.

6. There was discussion and disagreement about the present danger of inflation. Martin was greatly concerned about the revival of inflationary psychology in the last couple of months. He regarded inflation as a fairly imminent danger. He referred to talk of increases in steel prices and wages. He referred at some length to his long record as the opponent of inflation in the government. He was proud of the fact that although every other policy of the government - fiscal, market structure, etc. - had abdicated responsibility for inflation during the last 10 years, the Federal Reserve had fought it. He referred to the fact that the dollar was only worth 65 percent of what it was worth in 1946. Martin's moral objection to inflation extends to the point that he was unhappy that the Germans were having inflation, even though this was helpful to our balance of payments.

7. Martin was greatly concerned about the damage that has been done by inflation to the "credit of the government." He contended that the problem he's encountering in the bond market is just a part of the long run problem that people don't want to hold government bonds anymore because the credit of the government has been damaged. He regarded it as a real problem how to keep people willing to hold the Federal debt. Tobin suggested that in the recovery period we wish to encourage people to hold more private securities and real capital relative to Federal debt and other liquid assets, in order to encourage expansion in the private economy, and that that was the reason why we were trying to keep the attractiveness of holding government debt down. Martin didn't buy this theory of the purpose of monetary policy at all.

8. Discussion about unemployment revealed that there really is a basic disagreement between the Council and Martin with regard to structural unemployment. Martin does believe that a large part of the growth in unemployment is technological and structural and is not susceptible of remedy by expansion of money and credit. He believes that appropriate policy should aim at labor mobility and price reductions to pass on technological gains. Tobin and Heller attempted to get Martin to specify the percentage of unemployment that he would regard as a safe non-inflationary full employment level, but he would not do so. Tobin and Heller pointed out that a considerable expansion could occur during the coming year without getting below 5 percent unemployment, which would surely be enough to include structural and technological unemployment. Martin did not concur that a 10 percent expansion of output during the year could happen without causing inflationary pressure.

9. Martin feels that the Kennedy Administration is making the same mistake as the previous Administration in placing too great a burden on monetary policy. He had hoped that more use would be made of fiscal policies in both cases. (Presumably he means Eisenhower should have had tighter budgets to fight inflation, and Kennedy a more expansionary budget to fight recession.)

10. Martin referred to the strong pressure in the System against the policy of February 20. He said that at least 7 members of the joint group, Board plus Bank Presidents, 19 in all, voted with him for the policy against their own conviction. He said that the Advisory Council (private bankers) was against the new policy from the beginning and at its last meeting suggested that it be abandoned. He expected sentiment within the System for abandoning the new policy to become stronger now. Many people favor returning to dealing in bills to provide the bank reserves that the Open Market Committee deems appropriate.

11. Heller raised the question of the Presidential Message and referred to the political problem - the President is committed to the continuation of monetary ease and to getting interest rates down, at least keeping them from rising. Martin expressed his concern for this problem too. He said that he had an equal desire to keep the President from embarrassment on this point. Heller pointed out that we had left the whole task of clearing language for the message to the Treasury. Martin said so many draft versions had passed over his desk that he could not really say that he had "cleared" the language that finally appeared. The only phrase that distressed him in it was the phrase about choking off recovery. Heller and Tobin pointed out that this was added without the Council's knowledge as well.

12. Martin referred several times to the claim -- by Arthur Burns, by the present Council, and by many others -- that monetary restriction was in large part responsible for the premature 1960 downturn and for choking off the previous boom. This thesis has clearly stung him and he does not agree with it. His own theory of the downturn is that it was due to distortion of the cost and price structure owing to continuing cost push. He also defended the Board's actions in the preceding years, explaining that inflation was proceeding at an intolerable rate in spite of slackness in the economy.

13. Several times Martin referred to his own innocence of economics and economic training, but he said he does know the bond market - he is a bond man. He repeated the suggestion that we spend some time on the "desk" in New York to gain experience.

14. In response to probing by Heller for explicit assurances on future policy, Martin said he will continue to operate the new policy (of buying long-term bonds) and to maintain conditions of ease, providing bank reserves as necessary to maintain free reserves at the level of half a billion dollars and providing them mainly through the long-term market. He does not have, he points out, complete power and there may be restiveness in his Open Market Committee, but he does not anticipate an early return to bills only. He does not think it possible to get an easier policy, and he probably would not favor one himself. As stated above, he does not believe that this policy will prevent increases in government bond yields. And he does not agree with the Council as to the length of time during the upswing during which it will be possible and desirable to pursue the present policy of ease.

15. At the end, Tobin and Heller expressed their gratitude for the chance to have a real exchange of substantive views, and Martin said that this should be repeated every three weeks and that he would arrange to have Balderston at the next such luncheon.