INDIRECT CONTROLS: MONETARY AND FISCAL OPERATIONS OF THE FEDERAL RESERVE SYSTEM

24 March 1955 **2005**

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INDUSTRIAL COLLEGE OF THE ARMED FORCES

Washington, D. C.

Mr. William McC. Martin, Jr., Chairman, Board of Governors, Federal Reserve System, was born in St. Louis, Missouri, 17 December 1906. He was graduated from Yale in 1928, was a student in the Benton College of Law, St. Louis in 1931 and later did part-time post-graduate work at Columbia University. He served in the bank examination department of the Federal Reserve Bank of St. Louis, during 1928-29. In 1929 he joined A. G. Edwards and Sons, St. Louis, and became a partner in 1931. He was a member of the New York Stock Exchange from July 1931 to July 1938 and was a governor of the Exchange from 1935 to 1938. He was chairman of the Exchange Committee on Constitution during 1937-38 and was secretary of the Conway Committee set up to reorganize the Exchange. He was appointed president of the Exchange and served in that capacity until 1941 when he was drafted under Selective Service as a private in the United States Army. He was commissioned a first lieutenant in the Infantry and went through successive steps to the rank of colonel, holding assignments with the Munitions Assignment Board and serving as assistant executive of the President's Soviet Protocol Committee, and was awarded the Legion of Merit, October 1945. He was appointed by the President to the Board of Directors of the Export-Import Bank in November 1945; in February 1946 he was designated as chairman and president and served until he became assistant secretary of the Treasury, 8 February 1949. He is a trustee of the Foreign Service Educational Foundation, Washington, D. C. He was appointed to the position he now holds on 2 April 1951.

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GENERAL NIBLO: Our speaker this morning, Mr. William McChesney Martin, is well known to us all. He is constantly testifying before numerous committees of Congress. His comments and remarks are always newsworthy.

As you know from his biography, Mr. Martin was formerly President of the New York Stock Exchange as well as of the Export-Import Bank. At present he is Chairman of the Board of Governors of our Federal Reserve System. He will talk to us this morning on "Indirect Controls: Monetary and Fiscal Operations of the Federal Reserve System."

Mr. Martin, it is a pleasure to welcome you to the Industrial College and to present you to this year's class.

MR. MARTIN: General, gentlemen: Whenever I undertake an assignment of this sort, I always try to put myself in the shoes of the people who are going to listen to me so as to judge what I would like to hear if I were in the listener's place. I don't think there is any particular advantage in having a man in my position come over here and give you an academic talk. You, I understand, have had some background on the Federal Reserve System in your orientation work in this course so I don't intend to review the technicalities and procedures of central banking. What I think might be more interesting would be for me to try to say something in concrete form about contemporary current events.

When I was in college, I took a course in Alfred Marshall's first "Principles of Economics." Alfred Marshall was a great economist in my judgment, but I slept through that entire course. I never found anything so dull or so uninteresting as that course.

Ten years later, while I was in Wall Street, I went out to Columbia University and attended a course at five o'clock in the afternoon, after a busy day, in exactly the same first "Principles of Economics," by Alfred Marshall, only this time the teacher was a much duller teacher than the teacher I had had in college. In fact, I think he was the dullest lecturer I had ever listened to. He had no spark of humor and no

capacity whatsoever for making his subject live and breathe. And yet, because I was in Wall Street and had 10 years' experience in contemporary events and could think of these things, not in the abstract, but in concrete terms, I found that course as interesting as any dectective story I had ever whiled away the hours of the evening with.

If we are going to get any breadth out of the subject I am going to speak on this morning, we must look at it in concrete terms. For the specialists and pure students, it can be seen in the abstract, but for the majority of us it must be thought of in concrete and contemporary terms of the world we are living in.

So I would like to review with you briefly the transition from wartime controls to more reliance upon general controls in the field of money and credit. From that I believe you may be able to draw some lessons in which your judgment would certainly be as good as mine as to what use we might make of these controls in the event of another crisis or another war striking at any particular time.

Just one brief word about the Federal Reserve System. It was instituted in 1913. It is a major departure in the American scene because it represents a change from a more or less laissez faire approach to money and credit to a central bank approach in which we definitely took the course of a managed currency. Anyone who thinks that the Federal Reserve Act is not drawn in terms of managed currency has, I think, missed the evolution of the Federal Reserve System. For that act certainly gave the Federal Reserve System the responsibility for regulating the money supply of the United States.

The reason the American people turned to the Federal Reserve Act--with a good deal of trepidation and a good deal of fear on the part of bankers and businessmen generally--was the recurrence of money panics which finally reached a point in 1907 where the body politic were unwilling to accept them any longer. As a preventative measure, they were willing to take the plunge of managed currency.

In the preamble of the Federal Reserve Act, we are told that the purpose of the act is to provide an elastic currency, to afford a means of rediscounting commercial paper, and to improve supervision of banking. But over and beyond that it was a real effort to mobilize the reserves of the country.

Now, our banking system is a reserve system. Banks can lend in relation to the reserves which they hold. As the reserves increase,

the lending capacity of the banks increases. Without going into the technicalities of it, because I don't think that is important to you, for each dollar of reserves it has, a bank can, at present, lend roughly six dollars. In other words there can be a multiple expansion of lending when the banks acquire reserves. There is likewise a multiple contraction in lending when reserves are reduced.

Now, we are given in the Federal Reserve Act authority, within certain limits, to require member banks to maintain as reserves a portion of their deposits. By putting the reserves up, we can reduce the banks' ability to lend; by lowering reserves, we can release funds that can be used to expand loans. For the purpose of fixing reserve requirements, member banks across the country are divided into three categories: central Reserve city banks, meaning banks in New York and Chicago; Reserve city banks, meaning banks in most of the larger cities remaining; and country banks, though many of these "country banks" are fast approaching the stage where they are not really country banks in the original sense. In those categories, the reserve requirements permitted by law for demand deposits and the requirements presently in effect are as follows: Central Reserve city banks, legal range of 13 to 26 percent and present reserve, 20 percent; Reserve city banks, 10 to 20 percent range, with present reserve of 18 percent; country banks, 14 to 20 percent range and present reserve of 12 percent. We were given for time deposits, on which there is not the same pressure, permission to fix reserve requirements as high as 6 percent and as low as 3 percent. At the present time the requirement is 5 percent.

That is a general sketch of the framework within which the System is to act. The System, since its inception, has been sufficiently successful in terms of providing an elastic currency so that none of us has to worry any longer whether nickels and dimes or 5 and 10 dollar bills are available. The currency expands and contracts with the needs of the people so smoothly and so effectively that, although there are occasional shortages of individual items of pocket money, by and large they are not important, and they are quickly corrected. For example, if there is a shortage of pennies in one area of the country, pennies can be shifted there rapidly from elsewhere. In practice, this has worked very effectively and satisfactorily.

But the ability to expand or contract reserves, which is the real heart of the Federal Reserve System, has amounted to far more than a mobilizing of reserves that previously were so scattered as not to be

available in times of crisis. More important is the fact that, within the limits that the Congress set in the Federal Reserve Act, those reserves can be expanded or contracted at will by the managers of money. And more important still, new reserves can be created, if there is in their judgment an economic need for it. The amount so created could be very great--far in excess of existing amounts. Deposits in the Federal Reserve Banks, which are the reserves of the member banks, Federal Reserve notes issued, which are roughly 75 percent of the currency in circulation, could be expanded in fact until their combined amount reached four times the value of our gold certificates. Of course we can "extinguish" reserves as well as create them.

In essence, what the Congress has done is to take the power which it has over money and transfer it to an agency, the Federal Reserve System, which serves as a trustee of the money supply of the people of the country. The trust indenture is the Federal Reserve Act, and the trust indenture can at any time be changed by the Congress. But the trust indenture, having been enacted into law, cannot be changed readily by Congress, except through due process of law.

So that the trusteeship may be carried out, you have a body of individuals in the Federal Reserve System who are supposed to be insulated. That is where this word "independent" comes into it. By law, as a trustee, they are independent so that they exercise their authority free from political pressure on one side and private pressures on the other side, for so far as pressures are concerned, they are equally bad whether from political or private sources.

So much for the background of the way the system works.

Now, along comes World War II, and all of you in this room are familiar with the fact that only about 45 percent of our expenditures were covered by taxation. The balance was covered either by borrowing or by other means. If you compare that with the Civil War or if you compare it with the War of 1812, you will get different ratios, depending on how you compile the figures, but wars always are financed in large part by borrowing.

I don't think it is terribly important what the percentage is, but I do think it would be better to cover more of our expenditures by taxes. However, political pressures with respect to taxation are extremely heavy, as all of you realize, so nothing more need be said about that,

except perhaps to note that nothing we are talking about here today can be divorced from the recognition that what we are really struggling with here is human nature.

Now, what happened when World War II brought new economic problems on us? The answer is that we developed all the devices of control that could serve as substitutes for general monetary control. We had the War Production Board, and the Controlled Materials Plan with allocations and priorities of materials, and also price and wage controls and rationing. When you are trying to win a war, controls of that kind are effective and useful and will work, but they don't obviate the law of supply and demand. And when you create an addition to your money supply, as in financing a war with borrowed money, then no matter how you shore it up, you have a potential of inflation that has to be dealt with sometime.

Of course it is easier to be wiser when you look back upon the past. The only thing I am confident about in this field is that, whenever you are certain that you have the answer, you are riding for a fall. I think that you can distrust--if I may say so--the individual who has a formula or a precise answer to any of these questions. You have to realize that this is a process, a part of the business process that we are dealing with and that what you are attempting to develop is an approach, an attitude which will make it possible for you to achieve results.

At the risk of appearing trite, I would say that the prime requisite in the shaping of monetary policy is humility. Without an approach which, in one sense, goes back to the Biblical text, "The fear of the Lord is the beginning of wisdom," I think you are bound to be in trouble. But even with the proper approach, one would find himself lost in a fruitless field of endeavor if there were not certain guiding principles that are, in my judgment, inexorable. One of those principles is the tried old principle of the law of supply and demand.

You have to recognize that you can alter the course of supply and demand--change it or shore it up--but it is still with you. It is there just as much as is the law of gravity.

Now I want to discuss the period after the war ended. We were all worried about a depression. We didn't get a depression. We found that financing a large part of this war by inflation carried a price *in itself.* The heritage of all wars is inflation. It is among the evil effects of war. All of you know what happened to the purchasing power of the dollar.

It didn't become apparent for a number of years after the war; it would not become apparent as long as people were willing to accept, for patriotic reasons or otherwise, specific, direct controls. The trouble in a situation like this comes when you try to reinstate general control, that is, the control that affects the overall quantity of money--in the pool, the stream or level of credit. Then the trouble begins to arise, because nobody wants to be squeezed. We temporized a little bit in just such a situation in 1947. There were gnawing doubts and a good deal of hesitation, but little more.

Then along came Korea, and when Korea struck, the whole country went on a buying binge immediately. We had no general control to brake it, and no effective substitutes. There was a state of semihysteria over the lack of economic defenses. All of the controls that we were not really in a position to institute immediately were then thought of as alternatives to general control.

Many arguments were made against general controls, including some to the effect that "interest rates don't make much difference; exchange rates don't make much difference; it would be upsetting to the country." Much the same arguments were under way in other countries. So all over the world you had different sorts of attitudes on the question of whether general controls would have any validity after the war-spawned increases in governmental debts--in this country, from 45 billion in 1939 to 280 billion dollars which it rests at today. With this increased debt, some said, we couldn't possibly permit any adjustments in interest rates.

So, as the Korean hysteria began, it was apparent that we had to invoke all controls, but it was the general control over money that was invoked last. It was invoked, I might say, under necessity, under the pressure of this law of supply and demand rather than under an act of statesmanship by either the Treasury or the Federal Reserve. It was the pressure of supply and demand which brought about the recognition that general controls must be used.

What did we do? In 1950 we began to think about Regulation W, which regulated consumer installment credit, and we put that on in September of that year. Then we began to think about a real estate credit control, and we instituted controls on real estate--Regulation X. But since there are social problems in real estate as well as economic problems, the controls on real estate were not so drastic as they were, relatively speaking, on consumer installment credit.

Then, last of all, we thought about the stock market. As no one is a friend of the stock market, there was unanimity in the thought that you can put up margin requirements and get rid of speculators--especially if you forget that the country was built on speculation. When you get to the question of the difference between gambling and speculation, you are in a very difficult position indeed. George Washington bought stock in the Chesapeake and Potomac Canal that we pass comingdown here. I am sure his estate didn't realize anything on that; however, it was an addition to his portfolio at the time he did it.

But to go back to 1950--Idon't want anybody to misunderstand the situation at that time. The fact was that if we had invoked general controls which affect the quantity of money and the flow of money, we still would have had to have Regulations W and X. We would have needed everything in our arsenal. We had the voluntary credit restraint program in force at the time. We needed, in my judgment, all the weapons in our economic and financial aresenal to endeavor to keep the money and credit stream from overflowing its banks.

By the early part of 1951, it was obvious we would like to resort a little bit to general controls. So the first general control we thought of was this reserve requirement I have already sketched to you. Everybody said, "Let us increase the reserve requirement. After all, the banks shouldn't be allowed to lend all this money now, and that will be an excellent thing and that will be a step toward general controls."

Ah, but we had a pegged market. So increasing the reserve requirements without any more ado had simply meant that the banks sold Government securities to the Federal Reserve System--shifted Government securities out of their portfolio to the portfolio of the Federal Reserve banks so that the action actually had no effect whatever, except to pump up the money supply. So that aspect of money control was of no value whatever. How about raising the discount rate charge to banks when they borrow from the Federal Reserve? Well, there was no necessity for banks to borrow from the Federal Reserve System; they had Government securities they could sell at par. Why should they borrow, whatever the discount rate might be?

So that means of credit control was ineffective too. Meanwhile, in our position on the Government securities market--where we had to buy securities in great volume to maintain our rate pegs--we were like a man under Niagara Falls with only an umbrella to keep from getting wet. The volume of Government securities we had to buy under the

to Niagara's waters. The money pour-
as essentially a printing press creation of
To stop it, it seemed we would have to let some
market once again have a play.

ebate began in earnest, with much said about interest
r all, you would have to "go up to 6 percent to make any
e; or a difference of 1 percent wouldn't mean anything to
buying homes--they don't care whether they pay 4.5, 5.5, or
percent interest; if they want a home, they are willing to pay for
it." And, on the other side, "anyhow that won't be effective. Or, after
all, the Government debt is so large, if there is anything that rocks
the boat at all, it is going to spell disaster."

Well, we went through that period and we finally reached a point
where we had to recognize the forces of supply and demand. We un-
pegged the Government securities market. We unpegged it cautiously--
when a man has been on a drunk, you don't take him off liquor right
away; you must have a conditioning process. That was the process that
was applied to the Government securities market. We came cautiously
to a recognition that the credit mechanism would be permitted some
play--not free play entirely, but it would tend to be in the direction of
free play.

We found to our amazement--and I think history confirms what I
am saying now--that we didn't need a drastic adjustment; we didn't
have to go to 6 percent to have an effect; all we had to do was to fol-
low the business process of evaluating prices and put the price mech-
anism back into play. The effect was instantaneous and amazing.

A small adjustment in interest rates, with a debt as large as we
had, had a more far-reaching effect than any of us working with this
situation expected it would have. We found a change in the attitude of
insurance companies that had been buying mortgages in an endless
stream without even looking at them because, after all, they could al-
ways pass their Government securities on to the Federal Reserve at
a specific rate. No longer sure of being able to unload on the Fed,
they began to look at mortgages to see if they were as good as they
had been taking for granted. The whole process began to change, as
Government securities ceased to be interest-bearing money. The
credit mechanism again, as it should, began to be one of the gover-
nors in the flywheel of the economy. With it, you had some means of
measuring the money and credit supply in terms of usefulness and in

terms of what it was doing to the price level and, through the price level, to the standard of living.

Now when the general control was invoked, as always happens, there was the problem about going from one extreme to the other. For a long period of time, through this period of wartime controls, there had been the belief that general controls had no usefulness. Then when they demonstrated some usefulness, and then a little more usefulness, people began to think they had discovered something in the way of a millennium. They began to think this way: "If we ever have a recession in business, a decline, we can pump it up by inflating the money supply. It is going to be as simple as that."

I would like to recount an experience I had with the present President of Italy, Luigi Einaudi. He is, in my judgment, one of the really great economists of the world. In 1947--at the time of the convertibility crisis in Britain, this was before he took office in Italy--he was one of the first to say they ought to invoke general controls in Europe because it was perfectly apparent that direct, specific controls weren't working.

I had a brief visit with him in 1947 and he held forth to me for considerable length. He said the world would have to recognize that certain principles must be brought into play and that general control would have to be used by Europe if it was to stabilize its economy and ever get off the dole of the United States and restore itself to an earning position.

I listened intently and drank in what he had to say. I didn't think very much about it at the time. I did, however, notice what was happening in Europe as the move toward invoking general controls in Europe began to take place. You could see improvement in Holland, in Belgium, and in Italy of a very real sort. It brought a shift of emphasis, but still there was skepticism as to the usefulness of general controls.

In 1950, on a trip to Europe, I went in and had a little visit with Einaudi. I recalled to him the conversation I had with him in 1947, and said that I thought amazing progress had been made in Italy. He had a very quizzical smile. He said, "You remember it probably a little better than I do." Then he added, "What I said then has certainly taken place. It is perfectly amazing, but the people who didn't believe in general control now think we can solve even the population problem in Italy by money and credit control." So they had swung the whole circle.

Well, monetary policy can't do everything. You can't make people borrow money if they don't think they can make a profit on it. In sports terms, the monetary authorities are not so much like players on the field as they are like rooters in the stand--if I can make the distinction. Money and credit policy normally can be used to cheer the teams on the business field, but it can't get out on the field and substitute for the players. Under our system, money and credit are vital elements in the functioning of the economy, but it does have limits. Under a system of moderate intervention by Government, rather than maximum intervention by Government--and that is the system we are dealing with--you can't expect money and credit policy to go out on the field and actually play.

But I had better get back to my previous topic--and resume at the point where we finally invoked general controls in this country and found they worked surprisingly well.

You may have noticed in the paper this morning that for the last three or four months the cost of living index has been about 114.3, and really over the period since the summer of 1951 to the present time, we have had such modest changes in the cost of living index that there probably has not been a period in our history where we have had a more stable price level. That has been a contributing factor to the rebuilding of our economy.

Now the point that I really want to leave with you, because I think it is desirable in terms of thinking of war and what we can do in the event of another war or another conflagration, is that controls must be used in balance. Selective controls, that is the specific control on real estate or on consumer credit, in my judgment, can never be alternatives to general credit controls. They can be very valuable supplements to general credit control but they can never be alternatives. Stock market margins can be very valuable under certain circumstances, but they cannot be alternatives for general control because the total pool of credit is such that you will have leakage and seepage out of that pool from one segment of credit to another.

Now the degree of that leakage and seepage has to do with the psychology of the community. If you have a wartime period where patriotism exerts strong force in the community, price and wage controls cannot only be invoked but also can be effective, however unsound they may be or inept the individual who administers them. But without that sort of community backing and self-discipline, nobody is wise enough

to know how to put such controls on and make them effective. They have to be policed by the community itself. Otherwise, in a country as large as this, they can't be policed at all. Therefore, in considering the effectiveness of such controls, what you are dealing with is an estimate of the psychology of the community at a given time.

I happen to have sat on the Defense Mobilization Board when Charles E. Wilson (General Electric)--to distinguish him from the present Secretary--was chairman, and later under Arthur Flemming, the present chairman. I have seen exactly the same problems presented to both under differing conditions.

I would say in retrospect--and this is not in any way intended as criticism--the big problem Wilson faced was after the Korean hysteria was on us and we were doing everything we could to order our defense activities vis-a-vis our civilian activities. He was up against this sort of problem: Price and wage control authority he could get, but rationing was not politically feasible at the time. Quite a problem, in my opinion. For my book, when you have price and wage controls without rationing, you have lost one of your most important elements right at the start.

The feeling of the country with respect to the importance of the Korean War began to go downhill, and the turnabout was very quick after it started--to face the facts in black and white, rather than fit them to what you might desire.

I happened to be Assistant Secretary of the Treasury at the time and I certainly wouldn't have unpegged the Government securities market in the summer of 1950 or even in the fall of 1950. I have great sympathy for the then Secretary of the Treasury in the problem he was wrestling with. Granting all the points in favor of letting the forces of supply and demand operate, if there had been a Dunkirk in Korea, it would have been most unwise to unpeg Government securities.

In hindsight, it would have been wise when we were coming out of that period to use general controls across the board, but it is well to remember the need for a conditioning process in relation to money and credit, in almost any period.

Certainly during the first nine months of the Korean War, there was a real effort to use the same direct, specific controls, that were used during the war. But by the early part of 1951 there was not

sufficient backing--in my judgment, and it is only a judgment--in the country at large for the Korean War to bring out willingness for personal sacrifice by people, by citizens generally, to make possible the effective use of specific controls. Therefore, unless you were going to have a steady inflation, there was no alternative except to have general control, and in my judgment, general control is useful at all times. Its usefulness depends, though, on the degree in which you use it, and you have got to measure very carefully how you use it.

Let me just take my closing minutes here to consider recent periods in relation to the economy, apart from war.

What was the byproduct of this Korean hysteria? There are some people, certainly some of my friends in Congress, who believe that, if we had not permitted money to tighten under the force of supply and demand, there would have been no decline in business in late 1953 and early 1954. I believe some of that school is quite sincere in believing that if the Government just keeps on adding sufficient money to this pool of credit, we will create jobs through perpetual inflation and we would never have any pinch in our system! I consider that idea utterly asinine--if I may use the phrase.

Without pressing that point, I would say that whenever you go through a period of inflation such as the immediate Korean period--or the earlier inflation that was an aftermath of World War II--you superimpose on the economy a steady drain of waste, extravagance, incompetence and imprudence that will force some sort of correction eventually. We cannot all be winners all the time. I want to point out that our economy is a profit and loss economy, not just a profit economy. There are penalties as well as rewards in the economy. The distortions built up in the inflationary periods I spoke about made it certain that some business decline would have to occur at some point if we were to lay a base for the potential growth and development of an economy which is still growing.

Therefore, when 1953 came, we put on the brakes and they screeched, for we made some technical errors during that period. But we didn't make technical errors in terms of the money supply; we made errors in terms of the psychology of the people, the thinking of the community in regard to the volume of money. The error was made in the fact that the majority of people, looking at the pool of money and credit, were inclined to believe that by dipping into it they could solve any problem they had.

Now, when the decline in business got under way, we adjusted the money and credit pool to the new conditions. We just were making adjustments that had to be made through giving assurance that there was an adequate supply of money and credit.

We have at every juncture to contend with, among other things, the requirements of the Treasury. This was true at the time I spoke of, as it always is. Now the Federal Reserve System is a part of the Government and when we are talking about requirements of the Government, the needs of the Government, we have no right to ignore the appropriations made by the Congress. Whether we think they have appropriated too much or haven't appropriated enough, it is our job in the Fed to see that the Treasury is financed, though not at an arbitrary rate that the Treasury might think it should get. We cannot, in establishing that rate, ignore the forces of the market. For as long as the Federal Reserve and the Treasury ignore the forces of the market, the law of supply and demand cannot operate and the law of supply and demand must eventually operate just as the law of gravity. Therefore, we have to recognize it.

We came through this decline. A lot of waste, extravagance, incompetence, and imprudence was eliminated from the economy. Then came 1954 and a leveling off. Part of that leveling off was due to the sudden flareup in the Far East. We have many indications of a replenishment of inventories that would have continued to decline except that suddenly people began to think about Korea and World War II, and figure that maybe we would have trouble in the Far East. Therefore, they would restock a little bit. Inventory liquidation halted at this juncture and then the forces of recovery began to take hold. At the present time, we are in quite a substantial upswing in this country. How long it will last, I don't know. Automobile companies have changed their seasonal approach. It may end this year, but we won't know until the future.

"Never sell America short" is one of the sayings that I grew up with. I still believe it. You should never underestimate what the forces of a free and dynamic economy, with the extent of freedom that we have when unloosed and unleashed, can produce.

In our operations we have to bear in mind that general controls have validity only in relation to certain other factors that are more important than seasonal requirements in business. We have to equate these by the Federal Reserve Act. We intend to do the job.

One factor is Treasury financing. As I indicated, we have to help the Treasury get financed, but without ignoring the market. With the forces of the market at play, the Treasury will have to pay the rate of interest required by the interplay of demand and supply. The line between the Treasury debt management and money and credit policies is very narrow at times.

Senator Douglas, as some of you may have heard, said Congress ought to give a mandate to the Federal Reserve and the Treasury in this field, along the line that "good fences make good neighbors." My response to that on the stand--and I wouldn't change it if I had it to go through again--was that good fences do make good neighbors, but in this relationship a revolving door is needed in the fence so that you can go both ways. Unless there is this sort of intercourse, you can't achieve the results you are aiming at. The Treasury and Federal Reserve have to work together; they cannot be isolated.

Another factor we have to deal with is the growth requirements of a country where the population is increasing as it is in this country. That means that there is need that the monetary authorities should furnish additional money for growth, though not enough to cause inflation.

And a last factor is this matter of the psychological estimate of the community. The expectation of the market in 1953 was that we would pursue such a vigorous monetary policy that interest rates would rise indefinitely and therefore the balance in the market would be upset.

Now when you aggressively pursue an easy money policy, as we did from the summer of 1953 on through part of 1954, you get another psychological reaction. A conviction seemed to grow in this period that, after all, this Administration was no different from any other administration; they would just "inflate" vigorously in order to provide work and see to it that there was a minimum of unemployed. Therefore, you had any number of business boards in the country deciding they would eliminate bonds from their investments and go right into common stocks. So psychological reaction is a factor, no matter what course you take.

Realism requires acceptance that there will always be a community attitude, and it must be taken into account. Fortunately, the more education there is in the community, the more understanding there is of general controls and with it, a greater willingness to accept this type of control. Controls not accepted by a community, not understood by a community, and not shared by a community are seldom useful. That goes for war controls also.

I have already taken a little longer than I intended. But I want to add one thing about employment, which is a part of this process. I happen to be one of those who sincerely believe that inflation will not create jobs that can be sustained. If I thought you could tax people by depreciating the dollar and by that means create employment that could be sustained, then, so far as my personal wishes and philosophy are concerned, I would be an inflationist. But all my experience and work in this field has convinced me that inflation will not create jobs that can be sustained. Quite the reverse is the case, for inflation undermines the permanence of jobs that already exist without adding to the number of jobs to be filled. Whatever temporary result may seem to be gained by a little bit of inflation is offset, and more than offset, by the result it produces later. You will always have to recognize that inflation leads to depression. That, in fact, is why I am against it. When tempted to think that a little bit of inflation is a good thing, it is a good idea to remember that a price must be paid for it at some point.

One of my friends in Congress who disagrees with me on everything, repeatedly urges me to follow the course of inflation; he always wants to introduce resolutions that the Federal Reserve be compelled to buy Government bonds at par, regardless of conditions in the market.

It would be nice in many ways to have Government bonds always at par and still not interfere with the functions of the market. But if you are going to be compelled by fiat to buy Government securities at par, which means also to make Government securities a form of interest-bearing money, then I say to my critic I should have an appropriation from the Congress to run a truck back and forth between the Bureau of Engraving and Printing and the Federal Reserve banks throughout the country. He says, "I am not talking about the printing press." But that is what it comes to when you talk in those terms, and the use of the printing press is a very delicate and difficult thing. In terms of the problem you gentlemen are working on, it can be used, but it will carry a price. In war it may be useful, but don't forget that a price must be paid, eventually if not immediately.

Thank you very much.

QUESTION: I have been reading a good bit lately of the magnitude of consumer and mortgage credit; there are some people who think this is not a good thing. I presume the fear is that, if something set off a decline, there might be developments which might snowball and create chaos. What is the fear and what part would be played by the Federal Reserve System in such a thing?

MR. MARTIN: Well, there is no direct regulation on consumer credit today. There also is no direct regulation on real estate credit. As I stated earlier, Regulation X, controlling real estate credit terms, was not really very drastic. But then we have continued to make easy terms for real estate a conscious Government policy.

I might say there is quite a parallel between what is going on in Britain and what is going on in the United States. Nothing I may say is intended to be political in any sense of the word at all. But a conservative government comes back into power in Britain and there is a change in its housing policy. The Republican administration comes into power in the United States and, with a decline in business, they get more liberal in housing credit than the Democratic administration in any previous time.

Our easy-money policy contributed something to the availability of housing credit. A GI veteran doesn't even have to pay the closing cost at the present time. He can get a loan on a 10,000-dollar house without putting up a cent. If you went to the circus and bought a bag of peanuts, you would have to pay for it. That is how easy we have gotten in terms of real estate credit.

How to assess that--which is really what your question is--requires determining, among other things, whether you are overbuilt or underbuilt. It is my personal view that there are some islands in the country where we are overbuilt, but by and large we are still underbuilt. The demand for housing is still quite strong, particularly so in the case of commercial building.

I don't think we realize what the suburban shopping centers, the changes in home offices of various big corporations and plants around the country, parking facilities, and so on are going to do in the next few years to urban real estate. I question very much, regardless of how spectacular it may look in various areas we go into, whether we are overbuilt.

I am not an economist, but if we look at it purely from the standpoint of economics, I think we have been too lax on real estate credits. But after I say that, I must also add that I have great sympathy for the legislators and for the other Government officials concerned with housing problems because there are social as well as economic considerations in the housing question.

As to the spiraling credit operations that you mentioned, if we watch the overall pool of credit, I believe that we can minimize the seriousness of repercussions of that sort as long as there is marketability of those houses.

I want to move just a little bit to consumer credit by saying that I was much more concerned about consumer credit a year and a half ago than I am today. I believe consumer credit at 22 billion dollars today may appear large, but I believe that the dealers in consumer credit have a better grasp of what their problem is than they had a year and a half ago. And I am not afraid of its spiraling at this particular juncture, provided we keep the overall pool of credit in a position where the forces of supply and demand can work.

I had to go around the circle but it is an around-the-circle question.

QUESTION: Does your outfit have the right to raise margin requirements and make them retroactive on purchases I made a year before?

MR. MARTIN: I haven't looked into the legality of it, but as a matter of policy we wouldn't do it. I think we would have the legal right, but we wouldn't do it.

QUESTION: I, too, was reading about the ability of your organization, the effect of its control today versus the position in which your outfit was in 1929. The comparison was that in 1929, your ratio of reserves to liability was 80; today it is only 50. I don't know what it means. Is this meaningful and does it affect your ability to have control over the economy?

MR. MARTIN: That really doesn't mean a thing in those terms. Don't forget that Congress can always change the Federal Reserve Act if it has to. We are dealing with relationships.

I have found the most difficult thing for me to understand in my work in this period has been these relationships. That is true of gold, for example. You could work with anything else you wanted to besides gold, but you are just trying to have something that is responsive.

We can change the reserves in the banking system at will through reserve requirements, through discounts to banks, and through the purchase and sale of Government securities; we can either add to or subtract from bank reserves. Our reserve base, so long as we are

using gold as the limiting factor on our capacity for varying reserves--at least as the limit on our capacity for expansion--depends on the inflow or outflow of gold. If we didn't have an adequate gold supply, we would have to consider changing the ratio so that whatever gold supply we had would become legally "adequate" for meeting practical needs.

The limitation that is put on us by law is that the currency which we issue and the reserves which the member banks have with us cannot exceed four times our holdings of gold certificates.

Since the Federal Reserve Act, no bank can issue currency. That is reserved to us. Some of the old banks used to have their own bank notes.

Now 47 percent which is approximately the present ratio of our gold to our Federal Reserve notes and our holdings of member bank deposits, is an enormous ratio. I don't know whether you are right on the 80 percent in 1929, but in 1929, after the crash, for a few years we had excess bank reserves available, and lying idle, in huge quantities. Nobody thought they could make any use of the credit potential there. Money has no value unless it is put to work. And in a situation like that, the ratio we have talked about can be meaningless.

QUESTION: You mentioned the cost of living index not having changed since 1951. Do you pay any attention to the cost of living index in exercising your control?

MR. MARTIN: I cited that as an illustration, because the cost of living is one measure of the stability, or instability of the purchasing power of the dollar. It just happened to be in the paper this morning that the cost of living index was 114.3 and it has been 114.3 for the last three months. If my recollection is correct, it was 115 in the summer of 1951 and 115.1 in the summer of 1952. So using that one index, which is only one measure, it would seem that we have had relatively stable prices--that is, it doesn't seem to me that a variation in that index of, let us say, a point is very significant one way or the other over a period of several years. We have had very stable prices. That is why I was using that as an illustration. We are interested in the purchasing power of the dollar, which is related to the cost of living index. There are of course a great many factors that are not in that cost of living index that go into the purchasing power of the dollar.

QUESTION: You spoke of unpegging Government securities. Would you give some of the mechanics of how you unpeg Government securities?

MR. MARTIN: The agreement between the Treasury and the Federal Reserve up until 4 March 1951 had been that long-term Government bonds--the 2.5's--were pegged at par plus some twenty-two thirty-seconds. When we removed the peg after the new agreement or "Accord" of 4 March, we let the forces of supply and demand work; we did offer support for the price of Government securities, but on a descending scale.

Now, some went down to par almost immediately. I went through some rather exciting days. Then we bought quite a few around par. We bought some at 99.5 and some at 99. The price stabilized around 99 and held there for a period of nearly three months. But the pressure continued and gradually the price got down to 96.5 and then 97, where we were able to get it stabilized on its own for a period of nearly a year. Actually, we had no real upset in the market. And the Federal Reserve got out of the Government market except in times of Treasury financing.

Our agreement was that we would not step aside from the market when the Treasury was financing. In other words we agreed to act as somewhat of an underwriter, in the sense that during the period that the Treasury was floating an issue, we would buy and sell in a sort of stabilizing activity. Later, we got away from that. At the present, when the Treasury goes into the market, we don't support it at all. We have said that if market conditions changed from orderly to disorderly--which is a matter of semantics in one sense but the real substance of policy in another sense--we would step in. We have assumed the responsibility of stepping in if a disorderly market occurred.

QUESTION: Hypothetically, had the bonds gone down to 90 in 1951, would you have stepped in, bought them up at increased prices to bring them up again?

MR. MARTIN: No, I don't think we would have done that. But we were buying all the way down. I don't believe we would have let them go down to 90 at that time. We would have bought them up prior to that time. After all, we had to be pretty careful about an operation like that until we had reestablished a freely functioning market. For that you have to have a community that understands what you are doing. For 10 years the market had been more interested in finding out what the Federal Reserve was going to do, since prices were determined by its pegging, instead of studying the market. It is, by the way, still quite interested in what the Federal Reserve is going to do.

QUESTION: I was very much interested in your point on the estimate of the psychology of the community. When you make such an estimate if you do so explicitly, do you use means other than personal judgment and intuition?

MR. MARTIN: Well, I think that is the most hazardous field we are in. I think one of the advantages of the Federal Reserve System is that it is not a central bank here in Washington with X branches throughout this great country. Students of political science abroad, some of them, wonder how we operate.

We have 12 banks and 24 branches that cover virtually this entire country. Each of those banks has 9 directors. In all, the Federal Reserve banks and branches have roughly 250 directors. Each of these banks also has its own research staff. I don't want to exaggerate this, but we are funneling in constantly from Texas, California, the State of Washington, and so on, reports about the sentiment of the community, from people right there living in the community, doing their jobs there.

We frequently find, for example, that the people in Dallas are quite optimistic and the people in Chicago are not quite so optimistic. The Board of Governors has to exercise some judgment on that, but we are not just exercising our unsupported judgment.

The way we have tried to operate in the last four years is that, when I find my judgment at variance, say, with 75 percent of my directors, I begin to wonder if I shouldn't start changing my judgment. When we get 75 percent of this body more or less in agreement--the timing element comes into this also--that something should be done, then I think you have some understanding of the psychology of the period. Let me put it in concrete terms.

A year ago we were wrestling with the problem of what to do with the discount rate. If I had had my way, I wouldn't have reduced the rate at that time, but the Board of Directors of the Chicago bank came to the Board of Governors in Washington because the Board here has to approve a change in discount rates. It was the unanimous position of the Board of Directors of the Chicago bank that the prevailing rate should be reduced. They didn't give reasons particularly convincing, to me, but nevertheless they were a very eminent group of men; they had thought the problem through, debated it for three weeks, and then they had reached a meeting of minds and were unanimous that the discount rate should be reduced.

We had a week's debate here in the Board about it, and as I had already indicated my view on it, I said I wouldn't want to put my judgment ahead of theirs on a matter which seemed to be relatively insignificant at this point, because the effect of the discount rate then was largely psychological. The Board approved the change in the Chicago bank's discount rate, as proposed by the Chicago bank's directors. It was not very long before all the banks approved the same change. It actually turned out to be a pretty good move because it was more or less in tune with the psychology of the country.

We have control here within the Board of Governors in Washington, but the way to operate is to try to use the manpower you have--and we have 250 directors, around the country, giving their attention to this.

QUESTION: About a year ago in the recession we had, one got the impression from the press that in Government circles it was regarded as something serious, indeed a crisis at that time. You mentioned that you have contacts with the country through these directors. Did they feel we had to be concerned with the recession?

MR. MARTIN: My directors were completely at variance with that feeling in the Government. That is part of the problem that we will always have to wrestle with. I can say quite truthfully that there has been no direct pressure on the Board since I have been there to do things. There have been constant differences of opinion.

A number of people in Government in high places would have done things, if they had been on the Federal Reserve Board last January and February, that we refused to do. If we had turned out to be wrong, maybe I wouldn't be standing here this morning.

This matter of "pressure" always amuses me, as it sometimes is reported in the press. One of the newsmen found out that an important Government official thought the Federal Reserve was not taking this thing seriously enough a year ago. He came to me after he had gotten the story and asked me what I thought about it. He said, "That is terrific pressure. I don't see how you can resist it." I said, "I can't keep you from writing whatever story you want to write, but I don't call it pressure when a man in a Government office, including the President's, calls you over and says, 'I am pretty concerned about this situation'--the President didn't call me so that is a hypothetical point--'and I would just like you to know about it.'" I wouldn't call that pressure at all. I think that is perfectly within his right. If he said to me, "If you don't

do something about this, I will see that you get run out of Washington, Martin," I call that pressure.

DR. KRESS: Mr. Martin, we have come to the end of our time, and I think we will make you an economist. On behalf of the Commandant, and the faculty, I thank you for an interesting and informative session, and to compliment you on another thing, on which these men are evaluating you, a perfect example of public speaking.

(5 May 1955--250)S/sgh

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