William McChesney Martin, Jr.: A Reevaluation

BY JOHN H. WOOD

During his nearly 20 years as Chairman of the Fed, Martin helped to establish the institution's independence and to keep inflation relatively low, despite numerous pressures to follow a different course

It is high time that William McChesney Martin, Jr., is reevaluated. He was subjected to virtually unanimous adverse criticism from the economics profession during his tenure as the longest-serving Chairman of the Federal Reserve Board, from March 1951 to February 1970 (three months longer than Alan Greenspan). For instance, all 23 professors who appeared before Congress' hearings on "The Federal Reserve System after Fifty Years" supported Chairman Wright Patman's attack on the Fed's independence and the use made of it. Four, including Milton Friedman, favored money rules, and the rest joined Paul Samuelson in recommending the "coordination of monetary, fiscal, and debt policies" under the direction of the Executive.

This was before later monetary policies and inflations caused us to look back longingly at the record under Martin. Christina and David Romer have summarized monetary policy over "the past 50 years" as an "evolution from a crude but fundamentally sensible model of how the economy worked in the 1950s, to more formal but faulty models in the 1960s and 1970s, and finally to a model that was both sensible and sophisticated in the 1980s and 1990s." Average annual inflation in Martin's first decade was 2.2 percent compared with 7.1 percent and 2.5 percent in the 1970s and 1990s. The first period was also the least volatile, with a 0.87 percent standard deviation of inflation compared with 1.60 percent and 0.93 percent in the later periods.

Robert Bremner's recent biography, *Chairman of the Fed: William McChesney Martin, Jr., and the Creation of the Modern American Financial System*, fills a gap in the history of central banking, and of the financial markets generally. This is not only because of Martin's importance to monetary policy through two eventful decades, but also because, as the first full-time president (at age 31) of the New York Stock Exchange (NYSE), he guided its accommodations with the New Deal regulators who wanted to remake the financial markets. What we see is a tough and consistent man. His principles were those of a conserver — of institutions and the value of money.

Martin's life is a story of battles for those principles even when, as was usual, he was in the minority and had to use his considerable negotiating skills. He can be viewed as the most determined fighter in the history of the Fed. Without downplaying the successes of Benjamin Strong, Paul Volcker, and Alan Greenspan, they benefited from government forbearance and considerable approval from the academic community. The last half of Martin's term, however, was a fight, with limited help from a divided Federal Reserve Board, against easy-money administrations supported by the majority of economists. He was known at once for his collegiality in

William McChesney Martin, Jr., was sworn in as Chairman of the Federal Reserve System by Chief Justice Fred Vinson on April 2, 1951. Thomas McCabe, Martin's predecessor, looked on.

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the Federal Reserve and his firmness (approaching obstinacy, President Lyndon Johnson thought) in dealing with threats from the outside, both of which contrasted with chairmen Marriner Eccles and Arthur Burns.

Martin was a conserver even in his efforts in 1951 on the side of the Fed's independence. The reestablishment of the independence that had been taken away in 1933 (although its subordination was most obvious in the bond support program — the "peg" — which began in 1942) places Martin in the pantheon of genuine central bankers. By this I mean those who focused on price stability instead of thinking of the Fed's actions as part of a coordinated fiscal and monetary program aimed at multiple goals. Martin's overriding objective at the Fed and NYSE was stability, cooperatively if possible, digging in his heels when necessary.

Our knowledge of his conflicts is mainly from others, with a few from Martin's accounts for the Fed's files. Evidence of his backbone was shown during a meeting of the "quadriad" (President Kennedy, Treasury Secretary Douglas Dillon, Chairman of the Council of Economic Advisers Walter Heller, and Martin), when the "exasperated" President asked Martin "why he would not agree with his other advisers" and "Martin responded that he was the only person in the room that did not work for the President."

Martin's monetary policy was rooted in his background, and his actions at the Fed are better understood in light of his behavior at the NYSE in the 1930s and government service in the 1940s. The following discussion of Martin, the man, is taken largely from Bremner. The economic interpretations are mine. I hope the reader will agree that Martin's economic views were more sophisticated than he was given credit for.

Early Career

William McChesney Martin, Jr., was born in 1906. His father was appointed Chairman of the Board of the Federal Reserve Bank of St. Louis in 1914, and served as president (called governor before the Banking Act of 1935) from 1929 to 1941. The St. Louis Fed district was predominantly rural, and in his teenage years, junior often heard his father "expressing concern about excessive borrowing by overly optimistic farmers." Farm values rose dramatically with farm prices during and after World War I, before they both collapsed in 1921. One-fifth of the banks in the district (and the country) failed in the 1920s.

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Martin attended Yale, majored in English, and took some courses in economics, where, according to Bremner, he learned "that his father and other Federal Reserve bankers were considered hopelessly out of date because of their misguided warnings about excessive speculation in the stock market." The foremost economist at Yale during this period was Irving Fisher, whose pronouncement a week before the Crash that stock prices had reached a "permanent high plateau" became famous. Martin's behavior three and four decades later demonstrates that he took the lesson. My job at the Fed, he would say, is to "take away the punch bowl just as the party gets going."

After a brief stint as a bank examiner for the St. Louis Fed, Martin went to work for A.G. Edwards & Sons in November 1928, as a "board boy" who updated stock prices on a large chalkboard. His uncle, Albert Edwards, was managing director of one of the few significant securities firms away from the East Coast, which continues today with headquarters still in St. Louis. Martin soon became the sole member of a new research department. During the next few years he witnessed the financial ruin of many of Edwards' clients.

In 1931, he moved to New York as Edwards' floor broker at the NYSE. He took courses in economics and finance at night school at the New School for Social Research, and was a leader in the organization of the *Economic Forum Quarterly*. The journal included articles by John Maynard Keynes and Josiah Stamp, and Martin continued as one of the publishers until they sold it in 1934.

Martin began to study for a Ph.D. in finance at Columbia but his attention turned to the governance of the Exchange. In May 1935, he was elected a governor. The Exchange had been under attack since the Crash and the new Securities and Exchange Commission (SEC) pressed for reforms. Change was resisted by many, including Richard Whitney, head of the Exchange, but a few sought accommodation. Martin was new and unsullied and found that "the out-of-town firms were glad to support me" as a member of the reform movement.

He would rise quickly to the top of the NYSE, where he would serve as president for three years. Much of his presidency was devoted to preserving the Exchange's position in the financial industry and the profits of its members. He was generous with promises of audits and stricter supervision, but there was no significant change in membership or trading practices, particularly in the dealer functions of the vilified specialists. Bremner writes of the failures of Martin's reform efforts but one could view his record more charitably, as resisting the call to make widespread, and perhaps hasty, changes.

Martin resigned his position at the Exchange in 1941, and entered the Army as a private. He rose to colonel as he spent the war working on Russian lend-lease, becoming

head of the program in 1945. Being a Missouri Democrat did not damage his postwar prospects, and in November 1945, John Snyder, St. Louis banker and adviser to President Truman, asked Martin to become president of the Export-Import Bank. Bremner describes Martin's term at Ex-Im as a succession of run-ins with the State and Treasury departments as he defended the institution's independence of politics.

On Jan. 1, 1949, Martin became assistant secretary of the Treasury for International Affairs under Snyder, who had become secretary in 1946. He was involved in the negotiation of currency realignments following the British devaluation in September 1949, and for the occupied former enemies. He became Snyder's confidant on a wide range of policy matters, and was drawn into the Treasury's dispute with the Federal Reserve.

The Fed was fighting for its independence from the Treasury — not for the first time. To put the dispute in historical perspective, the Federal Reserve Act of 1913 created a System of 12 district banks with general oversight by a Board in Washington whose members were appointed by the President of the United States (five members with rotating 10-year terms, changed to seven members for 14-year terms in 1935). The Federal Reserve banks were owned by their member banks, and their heads were chosen by their boards of directors. So the Fed was given considerable freedom from the Executive — if it chose to exercise it, which is not possible in wartime because it is duty-bound to support the war effort. That means the monetization of government deficits. The Treasury kept up its pressure on the Fed to prevent interest rates from rising after the end of World War I, a policy that caused the consumer price index to rise 31 percent between October 1918 and June 1920.

The Fed was relatively free from early 1920 until Franklin Roosevelt became President in March 1933. Milton Friedman and Anna Schwartz have referred to the prosperous and stable-price 1920s as "the high tide of the Federal Reserve System." The massive falls in money, prices, and employment during the Great Depression of 1929 to 1933 produced a reaction in which the Roosevelt administration assumed control of monetary policy.

The only significant changes in the Fed's structure were made by the Banking Act of 1935, under the influence of Mariner Eccles, a Utah businessman who was attracted to Washington by the New Deal, and became Chairman of the Federal Reserve Board in 1934. The most important change affecting policy in the long run was the formalization of the open market committee that had been a voluntary vehicle for coordination between Reserve banks. The new Federal Open Market Committee (FOMC) consisted of the seven governors of the Federal Reserve Board, the president of the Federal Reserve Bank of New York, and four more Bank presidents on a rotating basis. The Chairman of the Board also chaired the FOMC.

Structural changes were irrelevant while monetary policy was directed by the Treasury, which decided on a low-interest war, in particular, a Treasury bill rate pegged at 0.375 percent, and an average yield on U.S. long-term bonds of about 2.4 percent. The administration's pressure to maintain low rates persisted even longer than after World War I. The peg continued unchanged until July 1947, and bills had risen to only 1.14 percent at the cyclical peak in November 1948, despite average annual inflation of 10 percent from 1946 to 1948. The long bond yield was virtually unchanged at 2.44 percent.

Throughout this period the Federal Reserve tried to negotiate the freedom to fight inflation. It had occasional support from Congress but the administration would not abandon its low-interest policy. The Fed's resistance increased with the inflationary pressures of the Korean War that began in June 1950, and it broke into open rebellion as President Truman's political position weakened. Martin represented the administration in negotiating the Treasury-Federal Reserve Accord that was announced on March 4, 1951:

> The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.

Part of the agreement was Martin's appointment as Fed Chairman.

Chairman of the Fed

Although coming to the Fed from the Treasury, Martin, like Paul Volcker later, insisted on the independence of monetary policy. Martin's long tenure was filled with conflict but his positions in all of them redound to his credit when viewed from later perspectives of monetary theory and policy. The distinguishing features of his career are seen in four conflicts that extended over the five presidential administrations during which he served.

(1) Bills Only. The development of open market operations as the main instrument of monetary policy meant that the Fed had to be concerned with the performance of the government securities market. Standards had been set for securities dealers during World War II but the stability and liquidity of the market were unthreatened under the peg. One of Martin's first actions at the Fed was to chair an Ad Hoc Subcommittee "to study and report on the operations and functioning of the Open Market Committee in relation to the Government securities market" under the new free-market regime

of fluctuating yields. The subcommittee's objective was effective open market operations, which requires "an efficiently functioning Government securities market characterized by depth, breadth, and resiliency."

This was remarkably similar to the goals of the New York Stock Exchange, which regularly publishes "indicators of market performance" consisting of price continuity, market depth, and quotation spreads. Martin's quiet obstruction of the SEC attack on the integrity of stock trading was carried over to the promotion of similar performance in government securities. His purpose was to achieve flexibility in the determination of bank reserves without interfering with the efficient transfers of saving to investment. Therefore:

> When intervention by the Federal Open Market Committee is necessary to carry out the System's monetary policies, the market is least likely to be seriously disturbed if the intervention takes the form of purchases or sales of very short-term Government securities.

Although the subcommittee's report correctly pointed out that "bills only," as the policy came to be called, was in "the best central banking traditions," it was received with hostility by economists for whom monetary policy meant the readiness to force sudden and substantial changes in interest rates, especially long-term rates.

Outside the interventionist academic atmosphere of the 1950s and 1960s, though, Martin is more easily defended. The prevailing IS-LM policy framework was a comparative-statics equilibrium model for given expectations. We have learned that short-term fiscal policies (such as the 1967 tax surcharge) which are known to be short term are ineffective. Ephemeral interest-rate policies may be even less effective. Whether the aim is reflation or disinflation, effective monetary policy requires the market's confidence in its seriousness. Martin's agreement is seen below.

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(2) Operation Twist. The "bills only" policy was terminated in 1961 under pressure from President Kennedy's New Frontier program, which demanded no restrictions on policy instruments. The last nine years of Martin's term were a continuous battle with inflationary administrations. Kennedy's advisers were inclined toward fiscal policy but came up with a challenging program for the Fed that aimed at the triple objectives of growth, balance of payments surplus, and price stability by twisting the yield curve. The Fed would stimulate long-term investment by buying long-term securities. At the same time, it would help the balance of payments by attracting short-term investments through the higher short-term yields that would result from sales of short-term securities. The program would not be inflationary because the added reserves from purchases of long-terms would be offset by the sales of short-terms.

The candidate had promised: "I have no doubt that any new Democratic President will find the Federal Reserve pursuing a somewhat different policy," and hinted that Martin might be replaced. After the election, when the chairman-designate of the President's Council of Economic Advisers Walter Heller called on Martin, the latter warned: "I'm not going to give up the independence of the Fed." But he added: "There's plenty of room for cooperation."

The administration persuaded Martin (despite dissents at the Fed) to nudge short-term rates upward while keeping long-term rates low. Operation Nudge turned into Operation Twist, which would involve vigorous actions to reduce long rates. "This is a historic reversal of policy," Heller wrote the

Martin served under these five presidents during his tenure as the Chairman of the Federal Reserve Board.

Harry S. Truman (1951-1953)

Dwight D. Eisenhower (1953-1961)

John F. Kennedy (1961-1963)

Lyndon B. Johnson (1963-1969)

Richard M. Nixon (1969-1970)

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President, "for which Chairman Martin deserves our appreciation."

Heller's satisfaction was premature. Several members of the FOMC "were strongly opposed to the end of 'bills only' [as] a step back toward political interference in monetary policy and a pegged bond market," wrote political scientist Donald Kettl, and Martin managed to obtain and keep the majority's support for Operation Twist only by an execution that bordered on the imperceptible. The administration was disappointed with Martin's "team spirit." The trouble, Heller recalled, was that:

> ... we'd have a meeting with Kennedy ... and before the meeting Bill would be out there buying those long-term securities, but afterwards his buying would flag. ... [CEA member] Jim Tobin would keep track of this and he'd say, "Walter, you'd better ... arrange another meeting ... because Martin isn't buying enough long-term bonds." So I'd call a meeting and sure enough the purchases would rise again, and Martin would be able to tell Kennedy, "We're doing everything we can."

Kennedy's advisers initially opposed the Fed Chairman's reappointment in 1963, but backed away from that position when they discovered the level of support for Martin in the business community, both at home and abroad.

(3) The Vietnam War and the "Credit Crunch" of 1966. The Federal Reserve was expected to finance government spending, and presidents had demonstrated that they would make a political issue of price and interest increases. Martin wanted to address inflation by monetary restraint, but in addition to political threats, he had to deal with increasing opposition within the Federal Reserve as the "New Economists" came to the Board.

Martin tried to steer a course between the Keynesians and the inflation hawks in such a way as to combat inflation without endangering the integrity of the Federal Reserve System. His difficulties were increased by the absence of any real discussion, or even understanding, with the Johnson administration. When Martin publicly warned that inflation might call for monetary restraint, Johnson's Chairman of the Council of Economic Advisers Gardner Ackley told the President: "I don't think we'll ever have a Chairman of the Federal Reserve who is so completely out of the mainstream of economics." Ackley's own 1959 paper on inflation had ignored money and "argued that the inflationary process is essentially an administrative one. It arises from a largely autonomous upward pressure on wage rates relative to the cost of living, interacting with administered-price markups applied to rising wage costs ... in endless chain."

The Board consisted of Martin, three Kennedy-Johnson appointees (George Mitchell and Dewey Daane, business economists from Federal Reserve banks, and academic economist Sherman Maisel), government lawyer James Robertson, appointed by Truman, and Canby Balderston and Charles Shepardson, college deans appointed by Eisenhower. The Vice Chairman of the FOMC was New York Fed President Alfred Hayes. Hayes, Balderston, and Shepardson were anti-inflationists who were usually joined by two of the rotating Bank presidents, while Robertson, Mitchell, Maisel, and two other presidents generally favored an easy-money approach aimed at keeping employment robust.

This five-to-five split left the deciding votes to Martin and Daane, who also leaned toward a policy of price stability. So, Maisel later wrote, decisions "generally favored the more restrictive targets. However, because a strong minority stressed broader objectives, as did the administration, moves to restrict credit were less frequent and more moderate; those in the middle had to be sure of themselves before they joined the restrictivists."

It was in this atmosphere that Martin urged the administration to ask Congress for a tax increase. When promises to do so were not kept, Martin obtained a commitment to act from a narrow majority of the Board. With his penchant for personalizing disagreements, Johnson announced to Martin: "I'm scheduled to go into the hospital tomorrow for a gall bladder operation. You wouldn't raise the discount rate while I'm in the hospital, would you?" Martin paused, and in a reply that became legendary at the Fed, said: "No, Mr. President, we'll wait until you get out of the hospital."

Treasury Secretary Henry Fowler's recommendation that Martin be replaced by Volcker (at the time, deputy undersecretary of the Treasury for monetary affairs) was not pursued, and on Dec. 6, 1965, the discount rate was raised. Johnson was enraged but the Fed kept up the pressure. Free reserves at member banks turned negative, and the Treasury bill rate rose from 4 percent to 5.5 percent. But inflation was not touched. In fact, the CPI rose 3.8 percent (at an annual rate) during the first six months of 1966 compared with 1.9 percent in 1965. Federal spending and the deficit continued to rise. However, the policy of restraint was ended by a "credit crunch" at the end of August.

Rising deposit rates threatened the solvency of institutions making long-term loans. In addition, banks and S&Ls lost time deposits because market rates rose above the legal maxima on deposit rates. The Fed gave way and resumed purchases. Martin resolved that next time they would stay the course.

(4) Richard Nixon. Though he campaigned on a largely conservative platform, President Nixon recoiled from the political costs of ending the inflation that he inherited. He did not trust Martin, whom he blamed for the recession that had cost him

the 1960 election, and wanted Arthur Burns at the Fed. However, Martin told the President that he would not step down before the end of his term on Jan. 31, 1970. In 1963, Martin had to be persuaded by Kennedy to accept reappointment and three times he offered his resignation to Johnson. Why the difference? Nixon did not seem likely to pursue more inflationary policies than his Democratic predecessors. That may be the answer. Kennedy and Johnson felt they needed Martin as a symbol of sound money and Martin knew it, whereas in addition to his personal animosity the Republican President did not feel the same need for a sound-money stamp.

Nixon's Council Chairman Paul McCracken hoped that inflation could be slowed without unemployment by a policy of "gradualism," when what was needed was just the opposite: to convince the markets that something significant was going to happen. Martin and the majority of his colleagues had stronger medicine than the Council's in mind. Worried about the administration's commitment and market expectations, they had raised the discount rate in December 1968, before Nixon took office. In February 1969, Martin apologized to the Joint Economic Committee for past errors and said they would not be repeated:

> It appears that the Federal Reserve was overly optimistic in anticipating immediate benefits from fiscal restraint ... but now we mean business in stopping inflation. ... A credibility gap exists in the business and financial community as to whether the Federal Reserve will push restraint hard enough to check inflation. The Board means to do so and is unanimous on that point.

He addressed the apparent lack of resolve on the part of the government, which "has raised the ghost of overkill at the first sign of a cloud on the horizon." *The New York Times* reported: "Martin strongly implied that this will not happen again and that restraint will persist even when there are clear signs the economy is slowing and in the face of some increase in unemployment."

The rate of money growth fell and unemployment rose, but inflation remained above 6 percent and the Fed raised the discount rate to 6 percent in April. The Fed kept its nerve until February 1970, when in Burns' first meeting, monetary policy changed direction. The rest, as they say, is history.

Conclusion

Martin voiced the same sense of failure in 1970 as in 1941. He had left the Fed at a time when inflation was on the rise, as he had left the NYSE without instituting major reforms. In his defense, however, he fought inflation as hard and as successfully as anyone could have done, and he preserved the Fed as he preserved the NYSE. Bremner may be right when he says that Martin's greatest contribution was the strengthening of the Fed as an independent monetary authority, although that independence still must be seized.

Skeptical of staff analyses and forecasts, he never saw any redeeming qualities in inflation. His statements did not meet the explicit standards of modern monetary theory, but the positions to which they referred were consistent with what is now thought to be the best in theory and policy. This includes his anticipations of later moves toward the transparency of the Fed's intentions and the willingness to take preemptive actions. **RF**

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