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Statement by

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before the

Senate Banking, Housing and Urban Affairs Committee

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I appreciate the opportunity to report to you again on the general condition of our economy and the conduct of monetary policy.

This past year has been a challenging one for the Federal Reserve. We had to seek a course for monetary policy that would help to check declining production and rising unemployment, on the one hand, while avoiding aggravation of a still serious inflationary problem, on the other. At times, conditions approaching crisis were present in financial markets, giving rise to sudden large increases in the economy's needs for money and bank credit. These needs had to be met, but in ways that would not compromise the longer-run objective of monetary policy--namely, to establish conditions in the money and capital markets that would serve as the basis for an enduring prosperity in 1971 and in the years beyond.

At the beginning of last year, the direction of monetary policy was reversed from the restrictive course that had been pursued during 1969 in order to curb excess demand. Interest rates at that time were at or soaring towards new peaks. Credit was in

short supply for a broad spectrum of borrowers. Housing activity was being restricted by the shortage of funds flowing into the major nonbank thrift institutions. With the liquidity of commercial banks at very low levels, funds available for business and consumer lending were severely limited.

Working together with fiscal restraints, the policy of monetary restriction pursued during 1969 succeeded in eliminating the excess demand that originally caused our inflationary problem. Aggregate demand had slowed so much, in fact, that signs of a business downturn were becoming increasingly evident. Monetary policy, therefore, needed to be altered so as to cushion developing weaknesses in the real economy.

It was of vital importance to accomplish a smooth and gradual transition from severe restraint to moderate stimulus. Inflationary expectations were still rampant, and would have been aggravated by too abrupt a shift in the posture of monetary policy. Furthermore, large segments of the business and financial community had come to believe that the Federal Reserve had lost effective control over the money supply, and would be unable to relax its restraint without releasing forces that would soon create excessively high rates of monetary and bank credit expansion.

Subsequent events demonstrated that these fears were unfounded. Growth of the principal monetary aggregates resumed at a moderate and well-controlled pace, as the System's open market policies added gradually to the supply of bank reserves. The resumption of deposit growth was also aided by adjusting in January of last year the maximum interest rates that commercial banks and nonbank thrift institutions could pay to attract time and savings deposits. By raising these ceiling rates at a time when yields on short-term market securities were beginning to decline, inflows of funds to savings accounts at commercial banks, mutual savings banks, and savings and loan associations were augmented, thus setting the stage for a sizable expansion in the supply of mortgage credit.

The smooth transition to a moderately stimulative monetary posture was accomplished partly through some changes in the operating procedures of the Federal Open Market Committee. Thus, in the conduct of open market operations, increased stress was placed on the achievement of targeted paths for the monetary aggregates. We shunned, however, the advice then being offered in some quarters that Federal Reserve policy should concern itself exclusively with stabilizing the growth rate of the narrowly-defined money supply--that is, currency and demand deposits.

The level of industrial production, the trend of employment, homebuilding activity, the movement of interest rates, stock exchange developments, fiscal policy, and other key economic and financial variables continued to play a central role, as they indeed must, in the determination of monetary policy.

During the spring and early summer months of last year, the most pressing problem confronting the monetary authorities was the need to assist the financial markets through a period of unusual turbulence. Tensions arose from a variety of sources-- including, as always happens in a time of stress, irrational fears of borrowers and lenders. In part, however, they stemmed from the lax corporate practices that had developed in the latter half of the 1960's. As a result of excessive reliance on short-term debt, especially issues of short-term commercial paper, liquidity positions of many corporations had deteriorated badly. Searching for ways to reduce the burden of current debt repayments, these firms converged on the bond market to fund short-term debt.

In the financial sphere, tensions in one market often spread quickly to others. The unexpected invasion of Cambodia in late April brought new uncertainties to the financial community at a time when a flood of new long-term corporate issues threatened to overwhelm the bond market. With the demand for liquidity

growing and interest rates rising, the success of a Treasury financing was seriously endangered in early May. In the stock market, where confidence already had waned, rumors that leading corporations were experiencing financial difficulties sent equity prices reeling, and confidence of financial investors was thus shaken further.

In circumstances that threaten disintegration of financial markets, the central bank must act promptly and decisively to stabilize markets and restore confidence. When liquidity pressures developed last spring, the Federal Reserve took a number of steps to bolster confidence and to permit liquidity needs to be met. In May, the conduct of open market operations was reoriented to give particular emphasis to moderating pressures in financial markets. Special assistance was provided to the Treasury during the period of its financing operation, and margin requirements were lowered on loans to purchase or carry stock.

Of particular importance were the actions of the Federal Reserve last June, in connection with the commercial paper market. The announcement on Sunday, June 21, of a petition by the Penn Central Transportation Company for relief under the Bankruptcy Act posed a most serious threat to financial stability.

This gigantic firm had large amounts of maturing commercial paper that could not be renewed, and it could not obtain credit elsewhere. A danger existed that a wave of fear would pass through the financial community, engulf other issuers of commercial paper, and cast doubt on a wide range of other securities.

By Monday, June 22--the first business day following announcement of the bankruptcy petition--the Federal Reserve had already taken the virtually unprecedented step of advising the larger banks across the country that the discount window would be available to help the banks meet unusual borrowing requirements of creditworthy firms that could not roll over their maturing commercial paper. In addition, the Board of Governors reviewed its regulations governing ceiling rates of interest on certificates of deposit, and on June 23 announced a suspension of ceilings in the maturity range in which most large certificates of deposit are sold. This action gave banks the freedom to bid for funds in the market and make loans available to necessitous borrowers.

These timely measures assured the financial community, and the nation as a whole, that the Federal Reserve stood ready to exercise fully its responsibilities as a lender of last resort, and thus to assist the financial markets through any period of stress.

Confidence was thereby bolstered, and a more tranquil atmosphere came to prevail in the business and financial community.

Over the remainder of the year, further open market operations by the System furnished banks with a substantial volume of reserves to ensure that liquidity needs were met and that developments in the money and credit markets would help to stimulate recovery in production and employment. In August, the Board announced a reduction in reserve requirements on time deposits, and at the same time extended the coverage of reserve requirements to commercial paper issued by bank affiliates--thereby putting such issues on the same reserve basis as large-denomination CD's. And as market interest rates fell, the discount rate was reduced in a series of steps from 6 per cent to the present level of 4-3/4 per cent.

Let us now take stock of what has been accomplished over the past year, as a consequence of the monetary actions I have been describing, to establish financial conditions conducive to economic recovery.

Last year, the narrowly-defined money supply--which had shown almost no growth during the latter half of 1969--rose by 5-1/2 per cent. This rate of growth was exceeded in only four

years of the post-war period--1946, 1951, 1967, and 1968. more broadly defined money supply, which includes--in addition to currency and demand deposits--the time deposits of commercial banks other than large CD's, rose by 8 per cent in 1970, accelerating from 6 per cent in the first half to 10 per cent in the final six months. A rate of growth higher than last year's increase has also occurred in just four other years of the post-war period--namely, 1946, 1965, 1967, and 1968.

The nation's commercial banks thus found themselves--as 1970 progressed--with an abundance of funds for lending and investing, and they proceeded to make large additions to their holdings of short-term Treasury securities and State and local government issues. Since the increase in available funds was greatly in excess of the demand for bank loans, banks also began actively to seek out prospective borrowers. Commitments of funds to the mortgage market rose; consumers found banks more willing to extend credit; and lending policies to businesses--both **small and large**--were relaxed. The prime rate of interest on bank loans was reduced from 8-1/2 per cent at the beginning of 1970 to 5-3/4 per cent at the present time.

The additional supplies of credit made available through

the banking system were a major factor in the rapid and wide-spread decline in interest rates last year. For long-term market instruments, the decline in interest rates did not get underway until the unusual liquidity pressures in financial markets had subsided. Subsequently, however, long-term interest rates declined more rapidly than at any time in the post-war period. Recently, a backing up of interest rates on long-term securities has occurred in response to exceptionally heavy corporate demands for long-term financing; but this upturn will, I trust, prove temporary. Later this year we might see long-term interest rates--and particularly mortgage interest rates--lower than they are now.

Short-term interest rates began to decline early last year, and they have continued to fall. In recent weeks, yields on three-month Treasury bills have been below 3-1/2 per cent--contrasted with a peak level of 8 per cent at the close of 1969. Even interest rates on consumer loans and mortgage interest rates, which often display downward inflexibility, have declined during the past several months.

As short-term market interest rates fell last year, the effects of easier monetary policies were increasingly communicated to nonbank financial intermediaries, especially the thrift

institutions. The rate of inflow of funds to mutual savings banks and savings and loan associations rose progressively over the course of 1970, and it is continuing at high levels in the opening months of this year. In fact, the volume of funds available for lending at these institutions has risen so dramatically that the supply of mortgage credit temporarily is outrunning the demand.

Thus, as I look around me, I see many of our nation's banks and other financial institutions aggressively seeking out borrowers. I see interest rates at much lower levels than a year ago and credit abundantly available. I see evidence that individuals, businesses, and State and local governments are responding to these changed credit conditions by increasing their rate of borrowing. Preliminary data on flows of funds in the fourth quarter of 1970 indicate that mortgage borrowing rose to an annual rate almost one-third above the level in the first quarter of last year, that the long-term security issues of our nation's major corporations rose approximately 40 per cent from the third quarter rate, and that the pace of borrowing by State and local governments actually doubled between the third and fourth quarters of last year. In the first two months of this year, business loans at commercial banks--which had declined in the

closing months of 1970--turned up again. These are signs, I believe, that ample supplies of money and credit are now available to finance a vigorous recovery in production and employment.

To be sure, the growth rate of the narrowly-defined money supply slowed from October of last year through January. This, however, was a result of the General Motors strike and other transitory influences, not of any shift in monetary policy. These transitory influences appear to have waned in February, when the money supply rebounded sharply. As a consequence of this rebound, the average annual growth rate since October has been about 6 per cent. Growth in the more broadly defined money supply, moreover, has actually accelerated in recent months.

Some of the effects of these larger supplies of money and credit on economic activity are already being realized. The vigorous revival of activity that got underway last spring in the homebuilding industry has shown no sign of losing momentum. Though housing starts declined in January from the exceptionally high December peak, the average level of starts for the two months was still 10 per cent above the November figure. State and local governments are now financing construction projects at lower interest cost; and with their new borrowing at an extraordinarily high level, a significant rise in public construction

seems likely.

In other sectors of the economy, underlying trends have been masked for the past six months or so by the effects of the prolonged auto strike on major economic indicators. Nonetheless, some of the principal economic series that usually signal the course of general business activity have shown a significantly stronger performance in recent months. Prices of common stocks have been advancing briskly since last summer. New orders for manufacturers' durable goods have now increased for three successive months. Industrial production rose in January, extending the advance that began in December. Recent trends in the markets for labor, meanwhile, seem to point to the development of a somewhat better balance between demand and supply. Initial claims for unemployment insurance have remained below their highs of last November, and the unemployment rate has edged down in the past two months.

A recovery in general business activity may thus be already underway, and if past experience is any guide, the forces of recovery should gather momentum as the year moves on. I think we can look forward to a pickup in consumer buying this spring--supported, to some degree, by the effects of rising

Federal expenditures on disposable personal income. Business capital spending should also strengthen as 1971 progresses--the encouragement coming in part from the recent liberalization of depreciation allowances. These developments should encourage an increased demand by businesses for inventories, in anticipation of a rising trend of sales.

The vigor of the business recovery during 1971 will depend importantly on consumer behavior. The mood of the American consumer has been cautious for the past year or more, in part because of renewed awareness of the hazards of unemployment. But a more important factor may well be the steady erosion of the real value of his income and his savings through inflation. The consumer at the present time is still trying to stretch today's income far enough to cover tomorrow's higher living costs. In an effort to accomplish this, he has cut down his current rate of spending and is accumulating liquid assets. And when consumer markets are weak, businesses lack incentives to invest in new plant and equipment, to increase inventories, or to add to their work force.

Economic stabilization policies in 1971, therefore, need to be designed to strengthen the confidence of consumers and

businesses. Given the present degree of slack in the economy, both monetary and fiscal policies must remain stimulative for a time. We must make sure that the recovery which now appears to be underway becomes a reality and gathers momentum. But we must also follow a course of policy that assures the nation's consumers and businesses that a new and yet stronger wave of inflationary pressures will not emerge.

Of late, some attractively simple but misleading notions have been set forth as to how these objectives can be accomplished. In one view, the significant factor limiting business recovery at the present time is a shortage of money and credit. Ensuring a prosperous economy in 1971, according to this view, can be accomplished readily by the simple device of forcing up the growth rate of the money supply to much higher levels than we have yet experienced.

This view starts, I believe, from an erroneous premise. The problem we face now is not a shortage of money and credit, but a temporary weakening of confidence among consumers and businesses in their own and the nation's economic future. This psychological mood stems to an important degree from the havoc wrought by inflation, and from public recognition that both the

inflation and the economic slowdown could have been prevented had we kept our financial affairs in order. We could make no greater mistake now than to throw caution to the winds in the conduct of our monetary and fiscal affairs.

The need for prudence in the management of our monetary affairs is reinforced by balance of payments considerations. True, our trade surplus improved significantly last year. Imports, however, are once again rising rapidly. Moreover, the overall balance of payments deficit remains uncomfortably large. Over the past year, the sharp decline of short-term interest rates in our financial markets caused interest-sensitive funds to flow abroad on a huge scale. Fortunately, the extent of this outflow may be limited in the year ahead by measures, such as those taken recently, which involve discouraging the repayment of Euro-dollar borrowings by our banks to their branches abroad, or the recapture of these funds through the sale of special securities to the foreign branches.

In view of the unhappy condition of our balance of payments, our government will have to give closer attention to this problem. Caution in the monetary sphere is required, lest a fresh wave of inflationary forces be released. Such a development could do

incalculable damage to the structure of international confidence and economic cooperation that has been built up over the past quarter century.

If confidence is to be strengthened, both at home and abroad, the proper course for monetary policy in the months ahead is to continue on the narrow road that we have been traveling--namely, to provide adequate, but guard against excessive, rates of expansion in supplies of money and credit. Of course, we must not allow ourselves to get stuck on dead center. If unfolding events in the months ahead suggest that monetary expansion has already been overdone, we must be ready to reduce the rate of monetary growth. On the other hand, if the economy fails to expand satisfactorily, a somewhat faster rate of monetary expansion may be needed.

We should be equally flexible in our thinking about the proper course for fiscal policy. If the rebound in economic activity does not keep pace with national objectives, we may need to consider additional fiscal stimulants--such as postponing the increase in the social security tax base, reinstating the investment tax credit, or advancing the effective dates of some of the income tax measures included in the Tax Reform Act of 1969.

In the present environment, however, we must carefully guard against the risk of increasing inflationary pressures. Let us keep firmly in mind the fact that we are starting a recovery at a time when the rate of inflation is still very high, and when wage rates are continuing to rise much faster than productivity gains. In these circumstances, monetary and fiscal policies may assure progress in reducing unemployment, but that alone will not meet our national needs. From a practical viewpoint, we face a problem unknown to earlier generations--namely, a high rate of inflation at a time of substantial unemployment. To meet this new problem, a multi-faceted incomes policy is needed to supplement our general monetary and fiscal tools.

The Federal Reserve Board has welcomed the steps already taken by the Administration to improve the functioning of our labor and product markets and thereby to reduce upward pressures on costs and prices. I hope the nation's business and labor leaders come to realize that unless they work together voluntarily to bring wage settlements and prices within more reasonable bounds, further actions by the Federal Government to accomplish these objectives may be unavoidable.

We have it within our power to reduce the major obstacles that are preventing us from enjoying reasonable success in our battle against inflation, and to move forward this year into a new and enduring prosperity. We must not forsake this opportunity. The confidence of the American people in the capacity of our government and in the viability of our free market system may be at stake.

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