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Statement by

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Joint Economic Committee

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I am glad to appear before this Committee once again to report the views of the Board of Governors of the Federal Reserve System on the state of our national economy.

The early months of the past year presented an extraordinary challenge to our national policies. Although a recovery had commenced in economic activity, it proceeded at a rather sluggish pace. Although the number of men and women at work was again rising, the advance was no faster than that of the labor force; hence unemployment continued at a 6 per cent rate. Although gains in productivity were resuming, they had yet to display the vigorous improvement characteristic of earlier cyclical recoveries. And, despite much idleness of men and equipment, wages and prices continued to rise at a virtually undiminished pace.

Moreover, the competitive position of the United States in international trade was deteriorating further, confidence in the exchange value of the dollar was weakening, and a massive shift out of dollars and into foreign currencies was getting under way.

In mid-August of last year, the President took bold and comprehensive steps to deal with these accumulated economic ills; for it had become reasonably clear by then that the performance of the economy was eluding our national goals.

The new economic policy had four major objectives: first, to slow sharply and at once the rate of inflation and thereby break the inflationary psychology gripping the nation; second, to set in motion forces that would stimulate more rapid expansion in aggregate demand and a decline in unemployment; third, to promote increased efficiency in our factories, mines, and other workshops; fourth, to set the stage for a reinvigoration of export trade, restoration of confidence in the exchange value of the dollar, and progress toward a sustainable equilibrium in the balance of payments.

The major new initiatives announced by the President included a 90-day freeze on virtually all prices and wages, to be followed by a more flexible price and wage policy; some selective reductions in taxes, including restoration of the investment tax credit; a temporary surcharge of 10 per cent on imports; and suspension of convertibility of dollars into gold or other reserve assets. The Congress in its turn moved with exemplary speed to enact the basic tax measures recommended by the President, and to strengthen the legislative basis for the new wage-price policy.

The nation responded with a sense of exhilaration to the new economic policy; for it meant that we as a people could and would deal energetically with our major economic problems--

inflation, unemployment, inadequate growth in output and productivity, and imbalance in international payments. A new confidence in our nation's economic future was felt all around.

But, as so often happens in human affairs, the first blush of enthusiasm gave way to a more cautious appraisal of the problems yet confronting the economy. Doubts gradually began to be expressed about the effectiveness of the control program that supplanted the freeze, about the strength of the economic recovery, or about the durability of the Smithsonian currency agreement negotiated last December.

These are understandable concerns and it would be foolhardy to dismiss them. Surely, we must recognize that uncertainty is inherent in all economic life, that the deep-seated economic problems we have been struggling with have not yet been solved, that more--perhaps much more--remains to be done to restore the conditions for lasting prosperity. Indeed, we must try to see to it that the momentum generated by the new economic policy of last August is sustained in the months to come.

But if all this is worth keeping in mind, it is all the more important to recognize the solid evidence of improvement that has occurred since last August in the economic and financial scene.

The brief freeze on wages and prices turned out to be an outstanding success. True, deferred increases went into effect when the freeze ended, causing an upsurge in average wage rates and to a lesser extent in prices. Nevertheless, both wages and prices have advanced at markedly lower rates since August 1971 than they did earlier in 1971. Moreover, demands for very large increases in wages seem less pervasive now than at any time in recent years, due in large part to the controls now in existence.

Financial markets have reacted constructively to this slackening pace of inflation. Interest rates have declined, as the inflation premium in the cost of credit has been whittled away. Yields on high-grade corporate and State and local government bonds have fallen about 75 basis points since last summer despite continued heavy demands on the capital markets. The rate of interest charged by some banks on prime business loans has dropped to the level prevailing in the early 1960's. Interest rates on mortgages have been moving down. And stock prices have risen significantly since August, reflecting the greater confidence with which individuals and businesses view the future.

This increased confidence has been evident also in markets for goods and for labor. Consumers stepped up their buying of new

cars and other durable goods last fall, and they were willing to go into debt to do so. This was a major factor in the quickening pace of economic activity in the fourth quarter. The demand for capital equipment, which had been conspicuously weak, is now appreciably stronger than last summer. And of late business firms have been adding substantially to their work forces; by the fourth quarter of 1971, civilian employment had risen more than a million from its level six months earlier, and a further significant increase occurred this January.

Gains have also been made in restoring confidence internationally. The readjustment of currency values negotiated in December by the Group of Ten countries was an event of far-reaching significance. While concern about international trade and finances has by no means ended, the uncertainties that had been troubling businessmen and the exchange markets have been greatly reduced. Confidence in continuing growth of the world economy and of international trade is now much stronger than it was last fall.

All these signs indicate that our people can look to the future with more confident expectations. The state of confidence, however, is always apt to be delicately poised in the early stages

of economic recovery. It is therefore vitally important, now that the Federal Government has become such a large factor in our nation's economy, that its operations and policies be conducted in ways that sustain the more confident public mood released by the new economic policy. If that is accomplished, the prospects will be very favorable for a quickening tempo of economic expansion in the year and years ahead.

Several major areas of private demand offer promise of additional stimulus to economic activity during 1972. Business inventory policies have been conservative throughout 1970 and 1971. As sales pick up, there will be a need to keep larger inventories on hand. Fixed capital expenditures by business firms should also move up. Over the past two years these outlays declined in real terms, so that a backlog of postponed projects has in all probability accumulated. Recent surveys already indicate a substantial rise in planned capital expenditures during 1972--an anticipation supported by a marked rise in manufacturers' new capital appropriations and the recent strengthening in new orders for capital equipment and in construction contract awards.

A more rapid pace of consumer spending may well be an additional source of stimulus in 1972. The rate of personal saving

has been abnormally high for an extended period, and consumers have accumulated large amounts of liquid assets that could be drawn down. The tax reductions resulting from recent legislation will provide additional support to consumer buying power this year.

As buying of goods or services goes up in one sector, its strength will be transmitted to other sectors, and the economic expansion will gather momentum. This is a familiar process in business cycle history, and it seems likely that we are even now experiencing such a development.

The Federal budget for fiscal 1972 that has just been presented to the Congress seems broadly consistent with the objective of more rapid economic expansion, for it embodies a good deal of further stimulation through both higher expenditures and tax reductions. I recognize that the budget deficit reflects preponderantly the shortfall in the performance of the economy. Yet, as I contemplate the future, the sheer size of the projected fiscal 1972 deficit--close to \$40 billion--gives me some pause.

To maintain the public confidence that is so vital to the achievement of faster economic expansion, I consider it crucial to make tangible progress toward a more balanced fiscal position in the 1973 budget and beyond. Whether or not the projected

revenues are realized will depend principally on the strength of economic recovery. On the other hand, the projections of further increases in expenditures are largely within the control of the Congress. I would urge, in keeping with the President's recommendation, that the Congress impose a rigid ceiling on fiscal 1973 expenditures--a ceiling to be treated as inviolate except in the event of a grave national emergency. This necessary discipline, which I have urged on other occasions, would go far to reassure the public that the Federal budgetary process is not out of control.

Let me turn now to the role that monetary policy needs to play in furthering national objectives this year. Clearly, our monetary affairs--no less than our fiscal affairs--must be kept in order, so that public confidence in our monetary management is maintained. An unduly expansive monetary policy would be most unfortunate, particularly in view of the large Federal budgetary deficits now projected. We need always to be mindful of the fact that increases in money and credit achieved today will still be with us tomorrow, when economic conditions may no longer be the same as they are today.

At this stage of the business cycle it is essential to pursue a monetary policy that will facilitate good economic recovery. Supplies of money and credit must be sufficient to finance the growth in consumer spending and in investment plans that now appears in process. Let me assure this Committee that the Federal Reserve does not intend to let the present recovery falter for want of money or credit. And let me add, just as firmly, that the Federal Reserve will not release the forces of a renewed inflationary spiral.

We are now in a favorable position to provide the monetary support needed for a quickening pace of production and employment. While expansion in the supply of money and credit was relatively brisk during 1971, we successfully avoided an unduly rapid growth of liquidity.

No single measure of money or credit represents adequately the impact of monetary policy on the economy. Let me nevertheless cite a few salient facts. Growth of the narrowly defined money supply--that is, currency and private demand deposits--amounted to 6.2 per cent during 1971, compared with 5.4 per cent in 1970. If the money supply is defined more broadly, so as to include also consumer-type time and savings deposits at commercial banks, the rate of growth was 11.1 per cent during 1971, compared with 8.1 per cent in the previous year.

These 1971 growth rates of money balances are at the upper end of the range witnessed over the postwar period. That is what should happen at a time of sluggish economic growth, as this Committee has pointed out.

The substantial increase of the money supply, as variously measured, was accompanied by abundant and readily available supplies of credit. Inflows of deposits at the nonbank thrift institutions were unusually large, and they permitted a record increase in the volume of mortgage borrowing. Residential construction was greatly stimulated, and new housing starts rose to unprecedented levels by the fourth quarter. Business firms were able to fund short-term debt and to rebuild their liquidity position. State and local governments too, finding a ready market for their securities, were able to expand fairly rapidly their outlays on public goods and services.

Interest rates fluctuated over a fairly wide range last year as financial markets were buffeted by international as well as domestic disturbances. In the spring and early summer, inflationary expectations worsened, and interest rates moved up despite the ready availability of funds. But they declined again after the announcement of the new economic policy in August. By the end of 1971, interest

rates on virtually all types of debt instruments had fallen below the levels prevailing at the beginning of the year.

Looking at 1971 as a whole, the growth in money and credit was, I believe, consistent with the needs of an expanding economy. There were, nonetheless, sizable variations in monetary growth rates--particularly in the narrowly defined money stock, which rose rapidly in the first half of the year and slowly thereafter.

These variations reflected the public's changing demand for cash balances, which is related not only to the need to finance current expenditures but also to the desire to hold money for precautionary reasons. Given the changing state of confidence during 1971, there is reason to believe that precautionary demands for cash intensified during the spring and then subsided following the August announcement of the new economic policy.

To some degree, however, the variations in monetary growth resulted from shifts of emphasis in monetary policy. Early in 1971, the Federal Reserve sought to promote a rate of monetary growth sufficient to make up for the shortfall in late 1970. With precautionary demands for funds burgeoning unexpectedly at that time, key monetary aggregates expanded at a faster pace than expected or than would have been desirable for any length of time.

Monetary policy, therefore, moved gradually during the spring and summer to restrain excessive monetary growth. Once again, the change sought was magnified during August by outflows of dollars to foreign money centers, and later--over a longer stretch--by an unforeseen upsurge of domestic confidence and consequently smaller precautionary demands for ready cash.

In recent months, the Federal Reserve has sought to encourage a faster rate of monetary expansion than occurred in the late summer and fall of last year. Open market operations have been conducted with more emphasis on increasing the reserve base of the banking system. In the five months from September through January, total bank reserves rose at an annual rate of over 8 per cent. Thus far, much of this increase has supported an accelerated growth in time deposits. But, in due course, the narrowly defined money stock, on which so much emphasis is nowadays placed by some single-minded observers, will also respond; preliminary calculations indicate that this aggregate rose more rapidly in January than in the immediately preceding months.

The additions to bank reserves have helped to move interest rates down in recent months, especially short-term rates. With the passage of time, this effect should become diffused as the additional

funds--the reserves and the deposits they support--are employed to finance consumer loans, or mortgage loans, or for other purposes. It would not be surprising, therefore, to see short-term interest rates rise somewhat as economic expansion carries the economy to higher levels of resource utilization.

On past occasions, a rise in short-term interest rates has more frequently than not induced a similar increase in long-term rates. At the present time, however, the differential between short-term and long-term rates is unusually wide. If further progress is made in dampening inflationary expectations, there need not be any rise in the cost of long-term funds. In fact, my hope is that further downward adjustments in long-term interest rates will occur in the months ahead, and that credit will remain in abundant supply for housing, for State and local construction, and for our nation's business firms.

Before closing, let me turn briefly to other financial and economic issues. I have already referred to the significance of the Smithsonian agreement of December 18. I have little patience with the view that this agreement will prove to be fragile. The nations participating in the negotiations last fall realized that much was at stake. They still do. All of us are compelled by our own economic interests to continue in the same spirit of cooperation that led to the agreement.

There is, however, much unfinished business at hand. Legislation is needed to permit a change in the official dollar price of gold, as called for by the Smithsonian agreement. This legislation will soon be considered by the Congress, and I strongly recommend swift approval.

Over the longer run, we and our trading partners must fashion a new and stronger international economic order. The issues are many and complex. A searching re-evaluation will be needed of the roles played by gold, reserve currencies, and special drawing rights in settling international accounts. Sufficient flexibility in exchange rates will be essential to prevent large and persistent balance-of-payments problems. The circumstances under which the dollar may again be convertible into international reserve assets will have to be reviewed carefully. And determined new efforts will be required to reduce impediments to the international flow of goods, services, and capital.

Progress in these areas will not be rapid. But it is essential to the health of every national economy, including ours, that we get on with the job.

In the domestic sphere, the most urgent need is to realize the promise of our present wage and price policy. The return to

a free-market economy will be speeded if the Pay Board and the Price Commission find ways to deal more successfully with outsized requests for wage and price increases. It is of great importance that the Pay Board resist pressures to reach compromises in specific cases that threaten to undermine its overall objective. The Price Commission is less subject to this hazard, since its decisions do not involve direct conflict between labor and management. Its efforts to hold down prices must be pursued with the utmost vigor, and yet leave sufficient scope for confident and constructive business behavior. For more rapid economic expansion is no less important at this juncture of our nation's history than bringing the rate of inflation down to 2-1/2 per cent by the end of this year.

The jobs of both of these bodies will be lightened if improvements in productivity accelerate. Our performance in this critical area has deteriorated in recent years relative to that of other industrial countries and of our own past. Resumption of rapid productivity growth is fundamental to our longer-term prospects. With higher productivity gains, we could have significant wage increases, larger profit margins, and numerous individual price declines within a framework of a stable level of average prices; our ability to compete with foreign producers would be greatly enhanced; and our national

aspirations for cleaner air and water, for halting the process of urban decay, for better housing, and a host of other things would be more readily achieved.

Elevating the growth rate of productivity will require a many-sided effort, with full participation by the public and private sectors. A larger commitment of resources to technical research and to new and improved capital equipment will be needed. Labor and management will also need to get together in joint ventures to increase productivity within the individual firm and plant. This can best be done by assuring workers that they will individually share in the benefits of improvements in output per manhour. Productivity councils at the community and plant level could help to achieve this objective, and--thanks to the initiative of the Congress--the National Commission on Productivity will shortly be initiating a program to establish such councils.

A serious national effort to increase economic efficiency should also include the most careful consideration of the steps needed to reduce abuses of private economic power, whether of business or labor. That, I think, is an objective toward which the great majority of the American people quietly aspire. Once our labor and product markets become more competitive, there will

be little or no need in the future for direct wage and price controls such as we have recently instituted. This, too, would strengthen the foundation of confidence on which our economy rests.

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