Federal Reserve System

Speeches Burns

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Federal Reserve Monetary Policy

Remarks of Arthur F. Burns,
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As I contemplate the problems of monetary stabilization that are now facing the United States, I am conscious of how closely interwoven our problems are with those of other countries. This interweaving of cause and effect is part of what I would like to speak to you about today.

I also have in mind, as all of us must have, the world's international payments problems -- the question, first, of how to maintain a reasonable degree of equilibrium in the international flows of goods and of capital, and second, the question of preserving and improving the machinery of the international payments system. No lasting cure for the world's international payments problems can be found without cooperative action by all countries. We at the Federal Reserve recognize that simple truth, but we also recognize that the United States itself can and must make an important contribution to international equilibrium by checking inflation and by maintaining orderly economic growth in our country. This is the central theme of my remarks today.

As I look around the world, I find strong inflationary pressures in one country after another. In the economies of the industrialized countries, inflation is more widespread now, I believe, than at any time since the middle 1950's. During the past year, increases of prices and wages have been especially rapid as well as widespread. Great strength of private fixed investment seems to be a major feature of the boom in many countries, as it certainly has been in the United States. Expectations of further price inflation abound. Desires for higher living standards are all-pervasive, and there is great faith practically everywhere in the will and ability of governments to maintain a high level of production and employment.

This state of affairs has obviously added to the difficulties of checking inflation in the United States. Strength in world markets influences our price level partly through the pull of demand for our exports, and partly through the upward push exerted by the high and rising prices of imported materials and manufactures. Moreover, in the United States as in other countries, expectations of continuing strength in world markets have undoubtedly been a factor tending to enlarge business investment in both fixed capital and inventories, thereby adding further to domestic and international demand.

Interactions of these kinds between the world economy and the economy of each nation are very familiar to you, I am sure. Nevertheless, despite rising world prices, some of your countries have succeeded in maintaining a remarkable degree of domestic price stability in the past year. That, I know, is attributable to your efforts in guiding monetary policy, as well as to the prudent actions of finance ministries and other departments of government.

In the industrialized countries, however, strong inflationary pressures have dominated of late, and they have pushed interest rates to unusually high levels. This has had important effects in Latin America, and I am glad that we are having a discussion of this question at our meeting here. On the one hand, high interest rates are bearing heavily on the balance of payments of those countries, including mine, that have had to increase their external indebtedness or refinance their debts in recent years. On the other hand, high interest rates in the world's financial markets have adversely affected a great many countries by stimulating capital outflows or impeding capital inflows, and by forcing domestic interest rates to higher levels than may be best for the promotion of economic growth.

The countries of Latin America have, I believe, an important stake in any decline that may occur in world interest rates. I wish I could predict that a substantial decline is close at hand, but any such prediction would be premature at a time like this, when the battle against inflation is far from ended either in the United States or in other industrialized nations. For two reasons, interest rates are likely to remain high so long as businessmen and investors in the industrialized countries continue to expect rising prices. The first reason is that forces of demand and supply add an inflation premium to market interest rates. The second reason is that central banks can hardly avoid putting additional upward pressure on interest rates, at least in the short run, through their actions directed at checking the inflation.

I am confident, however, that we are making progress in the fight against inflation in the United States, and that interest rates have already passed their peak. Let me indicate briefly how I view the current economic situation in the United States.

The Federal Reserve is trying to keep monetary policy on a narrow path in 1970. In view of the tendencies in recent months toward a slowing of economic activity, we are determined not to let monetary policy contribute to any further intensification of the slowdown. At the same time, we are equally determined to resist any re-emergence of excess demand later this year or in 1971.

We hope and expect that by keeping to a middle path we shall achieve a gradual cessation of price inflation in the United States, without having to incur the social costs of excessive unemployment and without throwing onto other nations the burdens that might result from a major shrinkage of U.S. demand for goods and services.

The need to check price inflation is acute and pressing. As you know, from 1958 on we had several years of virtual stability in our wholesale price level. But since 1965 the advance of prices has gradually accelerated, with the trend interrupted only briefly by the mini-recession of 1967. And now our wholesale price level, which has been rising at a 5 per cent rate during the past year, is more than 15 per cent above the level of five years ago.

The economic and social consequences of the continuance of price inflation at such a rate as this would be intolerable in the United States. I may cite, for example, the extremely difficult problems which already face our homebuilding industry, our municipalities, and our educational institutions as their costs, including interest rates, have mounted year after year. On the international scene, continuation of inflation in the United States would further impair our competitive position in world markets, and it would therefore accentuate the disequilibrium of international payments. These are some of the costs of letting inflation proceed.

On the other hand, the necessity of avoiding intensification of the present slowdown of economic activity is equally clear. Here again, the domestic and international costs of failure would be intolerable.

A middle course between continued inflation and a protracted slump in economic activity is, therefore, the prudent path of governmental policy. I believe this policy will succeed. As you know, since the third quarter of 1969, growth of aggregate real output and income in the United States has temporarily ceased, and unemployment has risen from its low point of about 3-1/2 per cent of the labor force to about 4-1/2 per cent now. There has also been a marked decline in the rate of utilization of industrial capacity. The decline in activity which we have been experiencing has not, however, acquired the pervasive or self-accelerating characteristics that economists usually associate with the declining phase of a business cycle. For example, business investment in fixed capital is continuing to boom.

While the driving force of excess demand practically disappeared by the end of last year, money incomes and prices have continued to rise.

But increases in prices and wages now reflect more and more the efforts of businessmen and workers to escape from the declines of real income thrust upon them by past increases in business costs and the cost of living. In short, we have moved from demand-pull inflation to a transitional phase in which cost-push adjustments are prevalent.

We look for a gradual subsidence of these cost-price pressures as the year progresses, with the current slowdown followed by an early resumption of economic growth. Fiscal policy will be playing an important role, at first in checking the decline in activity, and later by helping to prevent excessive growth of aggregate demand. Actions already taken by the Administration and the Congress will soon be adding significantly to the flow of disposable personal income in the economy. Later this year, and on into 1971, the Federal budget, especially on the expenditure side, will be moving in a restrictive direction, according to present plans.

A particularly important feature of the present situation has been the continued increase of business fixed investment expenditures. The need to expand capacity is great in such public utility sectors as electric power production and telephone service, the demand for which is steadily rising. In manufacturing, on the other hand, the drop in profits since the middle of last year is already having some damping effect on capital outlays, although two factors have been working against this -- first, an underlying optimism about future sales and production, second, a fear of rising future costs, which is prompting efforts to acquire new equipment of greater efficiency.

The tide of business fixed investment is thus still rising at the present time, and this strengthens our expectation that the growth of total activity will soon be resumed. But as time goes on we shall see a tug-of-war between the bullish attitudes I have described, and the more realistic views businessmen will take as they perceive that excess demand is not about to dominate the economy again. Sooner or later a tapering off in the expansion of business capital expenditures will occur. This will in itself help to prevent a re-emergence of excess demand.

Very large additions to our nation's capital stock have been made in recent years. With a widened margin between our productive capacity and actual utilization of the resources of the economy, forces of competition are being released to raise efficiency and to hold down costs and prices. Leap-frog adjustments of prices and wages will persist for some time, but gradually a stable structure of cost and price relationships is likely to be established if we persist on our present course of monetary and fiscal policy. Ultimately, the stabilization process should gain a momentum of its own, as expectations of further price increases become disappointed and then disappear. Clearly, the present moderate course of fiscal and monetary policy will be vitally important to the success of our efforts to restore a reasonable rate of economic expansion without allowing demand to become escessive again.

It is heartening to note that monetary and fiscal restraints in the United States, though they were designed primarily to combat domestic inflation, have already begun to have salutary effects on our international payments accounts. In recent months we have had a marked improvement in the current account, as a result of a rather slow increase in imports while exports have been responding well to the strong demand in world markets. It is our hope that the gradual checking of inflation and maintenance of orderaly economic expansion in the United States will allow normal growth of imports to proceed, but without recurrence of any such explosive increase as took place beginning near the end of 1967 and on into 1969. We expect also that the worsening of international price relationships -- the worsening, that is, from the point of view of the U.S. competitive position -- which occurred from 1965 to 1969 will be halted, if not reversed.

Let me make clear, however, that the United States has no intention of trying to regain external balance quickly by reducing its demand for imports, either of raw materials and foodstuffs or of manufactured goods. Our objective is to achieve longer-run benefits in the current account by improving our ability to supply goods to other countries at attractive prices. With growth in income and demand around the world continuing, favorable adjustments in international cost and price relationships would permit us to enjoy a long-run expansion in both our exports and our imports, while achieving gradual improvement in our current account.

We in the Federal Reserve are, as we must be, realistic about near-term objectives and expectations regarding the overall balance of payments of the United States. In particular, we recognize that the domestic economic slowdown we are now experiencing may affect capital flows adversely. During the year ahead the United States cannot expect a large inflow of private capital, such as we received in 1968 and 1969. The elimination of excess demand in the United States is bringing interest rate relationships that are less favorable, from the point of view of our balance of payments, than those that prevailed last year. It is likely that banks in the United States will repay a substantial amount of the funds they borrowed last year through their branches operating in the Euro-dollar market. There will continue to be large outflows of capital from the United States for direct investment in affiliated companies and branches abroad -- both in industrialized and developing countries. And other forms of capital outflow, including development assistance, will of course continue.

The ultimate restoration of a viable equilibrium in international payments will not come without cooperative effort by all countries, and especially by the industrialized countries of Western Europe and Japan. As recent history has demonstrated, these cooperative efforts can be extremely important in preventing disruptive short-term movements of capital in international markets. More fundamentally, however, we must work together to produce and maintain a structure of cost and price relationships that fosters stability in international financial markets and growth in world trade.

These achievements will be greatly aided by successful pursuit of the fight against inflation in the industrialized countries as well as in the developing nations. An expanding world economy free from inflation will provide the kind of environment in which the Latin American countries, as well as the United States and Canada, can best realize their own aspirations for economic growth.

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