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Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on International Finance

of the

Committee on Banking and Currency

House of Representatives

April 4, 1974

I am pleased to meet with this Committee once again to discuss with you recent developments in the international economy and in foreign exchange markets. My testimony today will focus on the grave problem of inflation and its implications for the role of the United States in the international economic and financial community.

Inflation is now the dominant economic force in every major nation around the world. Wholesale prices in the principal industrial countries at present are 10 to 35 per cent above their levels a year ago, while consumer prices have risen from 8 to 25 per cent in the past twelve months. Inflation is raging also in the less developed countries, and apparently in socialist countries as well as in those practicing free enterprise.

This February, wholesale prices in the United States averaged 20 per cent higher, and consumer prices 10 per cent higher, than their level a year earlier. Thus, along with most other nations, we are now either experiencing or are close to the threshold of a two-digit inflation.

The current world-wide inflation has no close parallel in the economic history of the industrialized world. In earlier times, inflation in the United States and in other industrial countries was usually associated with wars or, less frequently, with peacetime investment booms. Once those episodes passed, the price level typically declined, and many years often elapsed before prices returned to their previous peaks.

Over the past quarter century, a rather different pattern of price behavior has emerged. Prices of some individual commodities still decline when demand weakens. The average level of prices, however, hardly ever declines, even in periods of rising unemployment. The long-term course of prices, therefore, has been inexorably upward.

If my reading of history is correct, the ability to control inflation has gradually deteriorated since World War II. During the past ten years, moreover, the pace of inflation appears to have accelerated more in the United States than in other major countries.

Since 1970, prices have skyrocketed almost everywhere. For a time, between mid-1971 and the end of 1972, the rate of inflation in our country moderated substantially. Indeed, some nine or twelve months ago, the average level of consumer prices was rising less rapidly in the United States than in any other industrial country in the world. Of late, however, our nation has been experiencing a rate of inflation that matches or even exceeds the inflation rate of many other countries.

The implications of these facts have not been lost on the American people. Labor leaders and workers now tend to reason that in order to achieve a gain in real income, they must bargain for wage increases that provide full protection against advances

in the price level. Businessmen have come to believe that the trend of production costs will be steadily upward, and their resistance to higher wages or to higher prices for what they buy from others has therefore diminished. Lenders in their turn, expecting to be paid back in cheaper dollars, tend to hold out for higher interest rates. And when individuals and families set aside funds for the future, they realize that some part of their accumulated savings will be eroded by rising prices. A recent survey indicates that three-fourths of the consuming public doubt that the rate of inflation will be reduced at any time in the near future.

These new patterns of thought are an ominous development. When the thinking of a nation's consumers, its workers, and its businessmen comes to be dominated by inflationary expectations, productive efficiency is apt to falter, while interest rates rise, and social and political frictions multiply. That is the clear lesson of history both here and abroad. No nation that I know of has been able to maintain prosperous economic conditions for very long once inflationary forces got out of hand.

Last year's experience in the United States provides ample evidence of the troubles wrought by inflation. During 1973, weekly earnings of the average worker rose about 7 per cent, but consumer

prices rose even faster. With social security and other taxes also increasing, the real weekly take-home pay of the average worker was about 3 per cent lower at the end of 1973 than a year earlier. Inflation reduced also the real value of savings. Even if we take no account of the decline in the prices of common stocks, the dollar value of the other financial assets held by individuals rose less than consumer prices during 1973; in other words, the real value of these accumulated savings actually declined.

Many consumers have responded to the reduction in their real income and savings by postponing or cancelling plans for buying big-ticket items. Sales of new autos began to slip in the spring of 1973, and so too did sales of furniture and appliances, mobile homes, and new conventional houses. Inflation cut a wide swath through consumer markets last year, and thereby checked economic progress. The recent rise of unemployment reflects the weakness engendered by inflation in some consumer markets as well as the obstacles to production originating in shortages of petroleum products.

Thoughtful citizens throughout the country, as the members of this Committee well know, are deeply concerned about the erosion of the real value of their earnings and savings. Ironically, the roots of our persisting inflationary problem lie in the rising aspirations of people

everywhere for lasting prosperity, job security, and a fair distribution of the fruits of modern science and technology.

Public policies nowadays are expected to maintain production at a high and rising level, to limit such declines in employment as may occasionally occur, to ease the burden of job loss or illness or retirement, to protect business firms from the hardships of economic displacement, to sustain the incomes of farmers and wage-earners, to provide special credit facilities and other assistance to small businesses and home builders, and so on. We and other nations have moved a considerable distance toward these objectives. In the process, however, governmental budgets have often gotten out of control, business and consumer credit has frequently expanded too rapidly, wages have become less responsive to market forces, and in not a few of our businesses, price competition has atrophied as a mode of economic behavior.

In view of these institutional changes, general price stability would be difficult to achieve in the contemporary world under the best of circumstances. Of late, however, several factors of an unusual character have imparted a new dimension to the course of inflation in industrialized nations.

A major cause of the stepped-up pace of inflation during 1973 was the coincidence of booming economic activity in the United States and in other countries. Production rose rapidly throughout the industrial world; prices of labor, materials, and end products were bid up; and inflation accelerated everywhere.

Demand pressures became particularly intense for major industrial materials--that is, for aluminum, steel, cement, synthetic fibers, paper, paperboard, and the like. In some of these industries, productive capacity in the United States had grown little in recent years--a result of the low rates of profitability from 1966 to 1971 and, to some degree also, of the restrictions imposed by environmental controls. Since our industrial plant and that of other nations was incapable of accommodating the upsurge in demand, shortages developed for a wide range of materials and component parts.

To make matters worse, disappointing harvests in 1972--both here and abroad--forced a sharp run-up in food prices during 1973. And the manipulation of petroleum shipments and prices by major oil-exporting countries caused a spectacular advance in the prices of gasoline and heating oil. Rapidly rising prices of food and fuel, in fact, have accounted for a large part of the recent world-wide inflationary problem.

In the United States, an additional complicating factor during 1973 was the net decline in the value of our currency in foreign exchange markets. This depreciation of the dollar magnified the impact of world-wide inflation on our price level. Higher prices of foreign currencies raised the dollar prices of imported goods, and these price increases were transmitted to domestic substitutes as well as to finished products based on imported materials. Moreover, as the dollar became cheaper for foreign buyers, our export trade increased rapidly. While this helped our balance of payments, it reinforced the pressures of demand on domestic resources.

Before commenting further on the relationship between inflation and the international value of the dollar, let me turn to a brief review of recent developments in foreign exchange markets.

As you may recall, those markets were characterized by alternating periods of turbulence and stability during 1973. In mid-February, the dollar was devalued for a second time, and the dollar depreciated further in early March as floating became more widespread among major currencies. Then, over a period of two months, the dollar stabilized. During that time the average dollar price of ten major currencies (those of Japan, Canada, and eight European

nations) was some 20 per cent above the exchange parities that had prevailed in the spring of 1970. But after mid-May, the dollar again declined sharply; moreover, fluctuations of exchange rates from day to day became more pronounced. By early July market conditions had become so disorderly that the Federal Reserve decided to intervene by selling European currencies, mainly German marks.

The dollar reached its weakest point on July 6, when the average dollar price of the ten currencies mentioned earlier was 33 per cent higher than in the spring of 1970. In our judgment, as well as that of other students of the exchange market, this depreciation of the dollar was substantially larger than prevailing international price levels or long-term prospects for our balance of payments justified.

After our intervention in July and the release of new and favorable trade and payments figures for the United States, the dollar strengthened by about 3 per cent during the first weeks of August. There was little further net change in the dollar's value until late October, when the dollar began to strengthen in exchange markets. By the end of January the average dollar price of the same ten major currencies was only 11 per cent above its spring 1970 level--a drop of 22 percentage points from July 1973.

The decisive factor in the appreciation of the dollar from late October through January was the remarkable turnaround in the foreign trade and over-all balance of payments of the United States. Our merchandise exports expanded at extraordinarily high rates during 1973; in the fourth quarter, measured in current dollars, they were 53 per cent above their level in the fourth quarter of 1972. The value of imports also increased substantially, but not nearly as fast as exports. As a result, the trade balance, expressed in annual rates, swung from a deficit of \$7 billion in the fourth quarter of 1972 to a surplus of \$5-1/2 billion in the fourth quarter of 1973.

An impressive shift occurred also in the balance of payments as a whole. After registering deficits for fourteen consecutive quarters, the basic balance--that is, the aggregate of all current international transactions and long-term capital flows--moved into substantial surplus in the third and fourth quarters of 1973.

Although the improvement in our trade and payments position was the fundamental factor strengthening the foreign exchange value of the dollar during the October-January period, the dollar's appreciation was also propelled by market expectations that the energy crisis would have a more severe effect on the balance of

payments of European countries and Japan than on our balance of payments. These expectations seem to have weakened during February and March, and the exchange value of the dollar has declined appreciably since the end of January. Last week the average dollar price of the ten major foreign currencies mentioned earlier was about 20 per cent higher than in the spring of 1970--or close to the level at which it temporarily stabilized one year ago.

The most important factor in the recent weakening of the dollar appears to have been the reassessment by market participants of the probable effects of the world energy crisis on the balance of payments of individual countries. Foreign exchange traders have been impressed by the remarkable ability of German business firms to continue augmenting their exports, while passing on to buyers their sharply higher costs. Traders have also been influenced by the large borrowings in the Eurocurrency markets that have recently been negotiated by the governments of Italy, France, and the United Kingdom for the purpose of financing the trade deficits caused by higher oil prices. These developments in turn have led to some reassessment of the magnitude of the capital flow from the oil-exporting countries that is likely to end up in the United States.

Other factors have also played a part in the recent weakening of the exchange value of the dollar. The termination in late January of our controls over the outflow of capital contributed to market pressures on the dollar in February and March, and so too did the relaxation by some foreign governments of their restraints on capital inflows. There is some evidence, especially in connection with the strengthening of the Canadian dollar in February, that wider interest-rate differentials in favor of foreign-currency assets contributed to the recent dollar depreciation. During March, rumors of a revaluation of the German mark caused speculative flurries on several occasions. And the sharp rise in our price level that occurred in January and February has surely not gone unnoticed, and it may well have reduced in the eyes of some investors the attractiveness of dollar assets relative to assets denominated in foreign currencies.

The large fluctuations in exchange markets since the beginning of 1973 have reflected speculative trading as well as changes in real circumstances of individual nations--such as the improvement in our country's balance of trade and payments during the past fifteen months. The magnification of exchange fluctuations through speculative trading is a troublesome feature of a floating system. On the other hand, had it not been for floating exchange

rates, the financial world would probably have experienced a major crisis last fall. As things turned out, exchange markets absorbed remarkably well the shock produced by the abrupt and massive manipulation of oil shipments and prices by the major oil-exporting countries.

With many financial, commercial, and political issues still unresolved among the nations of the world, our own and other governments have no practical choice except to put up with floating exchange rates. But although exchange-rate flexibility is helpful under present circumstances, it is of course no panacea for the international problems facing our nation or any other. Indeed, unless we in the United States proceed with stronger determination than we have yet mustered to restrain inflationary forces, the consequences may be worse than they would have been when exchange rates were held within very narrow margins by official intervention.

Thus, if prices in the United States were to rise at a more rapid rate than abroad, our exports would become less competitive and domestic demand would tend to shift away from goods produced at home to imported products. Formerly, with fixed exchange rates, this lower volume of exports would have eased demand pressures on domestic resources; and the diversion of demand toward imports

would also have served to moderate upward pressure on our general price level. With floating exchange rates, however, a more rapid rate of inflation in the United States than abroad would tend to lead to a depreciation of the dollar in exchange markets. Such a depreciation, as noted earlier, results not only in higher dollar prices of imported goods, but also in higher prices of domestic substitutes and of finished products based on imported materials. Speculative anticipations of further weakness in the exchange value of the dollar could intensify this vicious circle of domestic inflation and exchange depreciation.

In short, with exchange rates floating, faster inflation in the United States than abroad would tend to induce a depreciation of the dollar in exchange markets, which in turn would exacerbate our inflation problem. No such intensification can take place under a regime of fixed exchange rates; or more precisely, it cannot take place as long as international reserves remain sufficient to obviate the need for devaluation.

There is another difference between the present system of flexible exchange rates and the former regime of fixed rates that requires attention. Under either regime, changes in interest-rate differentials between the United States and foreign countries will

tend to induce international capital flows. When exchange rates were held fixed, such capital outflows from the United States produced a decline in our net reserve position. Now, with exchange rates floating, capital outflows will tend to cause some depreciation of the dollar in exchange markets, and thus bring into play the unhappy consequences for our price level that I have already recited.

An important conclusion follows from this analysis of the interdependence between domestic inflation and the exchange value of the dollar, namely, that under the present regime of floating exchange rates, it is more necessary than ever to proceed cautiously in executing an expansionary economic policy.

Since the effects of floating exchange rates vary with circumstances, being helpful in certain respects and injurious in others, no responsible government is prepared to allow the international value of its currency to be determined solely by the untrammelled play of market forces. That is why the Federal Reserve and the Treasury have been cooperating with monetary authorities abroad--most recently in February and March--to moderate abrupt movements in exchange rates and to prevent the emergence of disorderly conditions in exchange markets. We in the United States certainly cannot accept with equanimity exchange-rate movements

that clearly undervalue the dollar. Nor would our trading partners want us to do that. Cooperation in managing the present exchange-rate arrangements is essential if the nations of the world are to minimize economic and political frictions and promote orderly expansion of international transactions.

Present uncertainties about the world economic outlook, in particular the consequences of the current energy problem, have increased the need for international cooperation in other areas as well. But effective cooperation requires effective leadership. The United States, being much the strongest economic and financial power in the world, is expected by the international community to provide the leadership without which lasting economic achievement may be impossible. Our government recognizes this responsibility, and exercised it effectively at the Energy Conference held in Washington this February. The nations participating in that conference agreed, as did also the Committee of Twenty in January, that every country must scrupulously avoid policies that are harmful to other countries--especially imposition of restrictions on trade and payments.

The United States in particular needs to ensure that declarations such as these at international meetings are more than fine rhetoric.

Constructive steps can be taken in three areas: facilitation of adjustment problems caused by higher oil prices, reduction of trade barriers, and international monetary cooperation.

The higher oil prices will generate an enormous flow of additional revenues to the oil-exporting countries. The capacity of these countries to expand their imports is very limited, however, in the short run. Therefore, even when oil prices decline this year or next, which I believe will happen, the oil-exporting countries will probably still experience huge surpluses in the current account of their balance of payments. On the other hand, we and other countries will probably experience sizable deficits. In principle, the essential means for the financing of these deficits are at hand, since the oil-exporting countries must invest their huge surpluses in some form-- in the traditional money and capital markets of other countries, or the Eurocurrency market, or through international institutions. Unfortunately, there is no assurance that the distribution of the investments of the oil-exporting countries will match the distribution of the current account deficits that their manipulation of oil prices has caused.

Many of the oil-importing countries that fail to attract these investments will be able to draw down their foreign-exchange reserves

or borrow in the Eurocurrency or traditional money and capital markets. But special cooperative measures will be required to assist countries for which these temporary remedies are not sufficiently available. Some countries, particularly among the developing nations, face oil-financing problems that are literally beyond their capacity to manage.

Oil-exporting countries themselves should play a major role in ameliorating the impact on the rest of the world of their sharply higher oil prices--first and foremost, by bringing down these prices to a more reasonable level, second, by providing massive assistance to the developing countries. Imaginative use can be made of existing financial institutions such as the World Bank, the International Monetary Fund, the Bank for International Settlements, and the Asian Development Bank; some progress along these lines is already visible. The Federal Reserve's own network of reciprocal currency arrangements can play a modest role by temporarily financing short-term movements of funds; to this end, the swap lines with the Bank of Italy and the Bank of England have recently been expanded, each by \$1 billion. We should also explore new instrumentalities, such as the multinational joint-venture arrangement mentioned as a possibility by Secretary Shultz at the Washington Energy Conference.

These financial measures can be helpful in the short run while other measures, that will only become fully effective in the longer run, are being taken. The long-run solution of the energy problem is not yet clear beyond the fact that it will require massive programs to conserve energy use, to develop new energy sources, and to accelerate energy research. Project Independence, outlined in the President's Budget Message, is designed to advance these programs in the United States; and the Washington Energy Conference has also agreed to seek methods of international cooperation with regard to such matters as the conservation of energy, the sharing of nuclear and other technologies in the energy area, and research aiming to develop or hasten the exploitation of new energy sources.

Reduction of trade barriers is a second area in which increased international cooperation can play a useful role. The Congress can do its part by speedily enacting the Trade Reform Act. Other countries must also make an earnest effort to move trade negotiations forward. In the meantime, we should insist that the nations of the world bind themselves to avoid bilateral agreements that give support to cartel arrangements. We should also seek agreement--in case of balance-of-payments difficulties--not to impose new restrictions on imports, or artificially stimulate exports, without IMF approval.

International monetary reform is the third area in which useful cooperative steps can be taken in the months ahead. I see no reason for being discouraged by the progress made to date by the Committee of Twenty. The Committee and its Deputies have been laboring under difficult circumstances. I have never expected international monetary reform to be blueprinted in advance, so that it could be methodically implemented all at once. International monetary reform is bound to be an evolutionary process and to reflect unfolding experience.

I expect the Committee to reach agreement this summer on the basic principles and broad features of a reformed international monetary system. This agreement should lay the basis for considerable strengthening of the International Monetary Fund. Hopefully, a new high-level Council will be created in the IMF; this body will be charged with the responsibility of continuously reviewing the structure and operation of the international monetary system. I also believe that agreement can be reached this summer on several vital monetary arrangements, such as guidelines for floating, the valuation of special drawing rights, and guidelines for an adjustment process in which individual countries avoid persistent increases or decreases of their international reserves.

I am bound to observe, however, that no set of international monetary arrangements can function successfully in an environment of rapid inflation such as we and other countries have recently been experiencing. The paramount task to which economic policy in all countries must be devoted at the present time is firm control over the inflationary forces distorting the world economy. It is particularly important that the United States, to which so many countries look for leadership, bring its own inflation under control. By setting an example for other countries, we will aid them as well as ourselves.

Improvement in price performance during 1974 is essential to our future, and is also within our means. The rise in consumer prices should moderate later this year as petroleum prices level off or decline in response to increased supplies of gasoline and fuel oil, and as food supplies expand in response to incentives for farmers to increase production. There are other favorable price developments on the horizon. A temporarily slower pace of economic activity, both here and abroad, should cause a decline in the prices of industrial raw materials and internationally traded commodities. Actually, wholesale prices of farm and food products have declined appreciably in recent weeks, and prices of cotton and some other industrial materials have also edged down from previous peaks.

Realistically, however, we can hardly expect a return to general price stability in the near future. Substantial increases in the prices of numerous commodities and services are practically unavoidable this year, since relative prices of many items are now badly out of balance. Moreover, despite the restraint shown in most wage settlements during 1973, increases in wage rates are running well ahead of productivity gains, and unit labor costs are rising rapidly. If economic activity proceeds rather sluggishly this year, as seems likely, productivity gains will probably be even smaller than they were last year. A rise of wages that is faster than we have recently experienced would therefore put great upward pressure on costs of production and on prices.

Whatever the cause, if rapid inflation continues this year, it may undermine confidence, cause interest rates to move higher, and seriously diminish our chances of regaining a stable and broadly based prosperity. It may also destroy the gains recently made in improving our competitive position in world markets and in strengthening our balance of payments.

Public policy at the present time is confronted with an exceptionally difficult economic situation. Inflation is proceeding at a dangerous pace, economic activity is high but sluggish, and inter-

national financial relations are under strain. Our best chance of surmounting these accumulated difficulties is to face up squarely to the gravity of the inflation problem. The pace of inflation needs to be substantially reduced, even if it cannot be halted, this year.

Our chances of bringing inflation under control will be enhanced if our nation's business and labor leaders exercise restraint in the wage-price area. Governmental programs to improve productivity and to encourage larger output of products in short supply could also be of benefit. But in the end, we will have to rely principally on prudent management of monetary and fiscal policies. For our part, we at the Federal Reserve are determined to follow a course of monetary policy that will permit only moderate growth of money and credit. Such a policy should make it possible for the fires of inflation to burn themselves out, while it at the same time provides the financial basis for the resumption of orderly economic growth.

In the present economic environment, fiscal policy can be used to better advantage than monetary policy in alleviating unemployment. Selective measures such as an expanded public employment program, or increased unemployment benefits, could cushion the economic adjustments now under way. Also, a selective tax policy of accelerated amortization could stimulate investment in

the energy and other basic materials industries, thereby relieving the more critical shortages of capacity that have recently proved so troublesome. I would strongly advise the Congress, however, against adoption at this time of broadly stimulative fiscal measures, such as a general tax cut or a new public works program.

In closing, I cannot let this opportunity pass without expressing great satisfaction that a bill reforming Congressional budget procedures is now in conference and will soon become law. After long and conscientious study, the Congress has developed systematic procedures for setting an over-all spending limit that will be rationally related to both expected revenues and economic conditions, and then establishing spending priorities within that limit. These new procedures should end the practice of persistently running budget deficits--deficits which have appeared in good times as well as bad, and which very frequently were unplanned and unwanted by either Congress or the Administration. This landmark legislation will enable us to avoid excessively stimulative fiscal policy, which has been a major source of the inflation during the past decade. It will enable us at long last to use fiscal policy effectively, to restrain demand as well as to stimulate it. Used wisely, it has enormous potential for restoring price stability in the future.

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