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Statement by

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before the

House Budget Committee

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I welcome the opportunity to meet with this Committee as it assumes its responsibilities under the Congressional Budget Act of 1974.

As you well know, our nation is struggling with a grave inflationary problem. The economy has been damaged, and our people are deeply concerned. More determined action to curb inflation has therefore become an urgent need. The discipline that this Committee -- and its Senate counterpart -- can impart to the Federal budget may be a decisive factor in our nation's ability to regain control of its economic destiny.

The inflation in which we are so deeply enmeshed began to spread across the economy ten years ago. The problem has steadily worsened, with only an occasional respite. The level of wholesale prices is now about 18 per cent above a year ago, after rising almost 4 per cent in August -- the largest increase in more than a quarter of a century. Consumer prices advanced another 1.3 per cent in August, and are 11 per cent above a year ago.

Inflation has been eroding the purchasing power of both consumers and businesses. The take-home pay of the typical worker declined materially in real terms during the past year, and so too did the real value of the public's savings, pensions, and life insurance policies accumulated over the years. Corporate profits have

also suffered -- a fact that is concealed by accounting techniques that have come down from inflation-free times.

As a result of the inflation, financial markets have been experiencing severe strains and stresses. Interest rates have soared, and stock prices have plummeted. Some financial and industrial firms have found it more difficult to roll over their commercial paper or to raise needed funds through other channels. Savings flows to thrift institutions have shrunk, and the flow of mortgage and construction loans has sharply diminished.

In short, as a result of the inflation, much of the planning that American business firms and households customarily do has been upset. Confidence has deteriorated and the driving force of economic expansion has been blunted.

It should not be surprising, therefore, that the physical performance of the economy has been sluggish in recent months. With consumer incomes eroding, the demand for new autos, mobile homes, household furnishings, and other durable goods has weakened. The home-building industry has been hurt not only by the shrinkage of consumer incomes, but also by rising land prices and construction costs, the high interest rates, and the shortage of mortgage funds. Industrial production is running 2 per cent below the peak of November

1973, and employment in manufacturing since then has declined by almost 300,000.

Public policy is thus confronted with a most difficult problem. The forces of economic expansion have weakened to a point where, in earlier times, serious consideration would have been given to stimulative monetary and fiscal policies. In present circumstances, however, such measures would aggravate an already grave inflationary problem and plunge our economy before long into even deeper trouble.

Defeat of inflationary forces must remain the major goal of public policy. We cannot realistically expect a resurgence of economic activity until the confidence of our people in their own and the nation's economic future is restored.

I have noted on prior occasions that a large part of the current inflationary problem is due to special factors. In most years, the economies of different nations follow divergent trends. In 1973, however, a business-cycle boom occurred simultaneously in the United States and in every other major industrial country. With production rising rapidly across the world, prices of labor, materials, and finished products were bid up everywhere.

The effects of the worldwide boom on our price level were magnified by the depreciation of the dollar in foreign exchange markets. With larger export orders adding to expanded domestic requirements, demand pressures became particularly intense in the materials-producing industries, where expansion of capacity has been slight in recent years. Severe shortages developed, and prices of basic materials shot up.

Disappointing crop harvests and the manipulation of petroleum prices by oil-exporting countries have also imparted an upward thrust to the general price level during the past year and a half. More recently, prices and wages have reacted strongly to the removal of direct controls.

These special factors have played a prominent role of late, but they do not account for all of our inflation. For many years, our economy and that of most other nations has been subject to an underlying inflationary bias which has merely been magnified by special influences.

The roots of that bias lie in the rising expectations of people everywhere. Properly directed, this human drive is a powerful force for improving the general welfare. But individuals and business firms have in recent times come to depend more and more on government, and less on their own initiative, to achieve their

economic objectives. In responding to the insistent demands for economic and social improvement, governments have often lost control of their budgets, and deficit spending has become a habitual practice. In many countries, monetary policy has supplied an inflationary element on its own, besides accommodating fiscal excesses.

The course of Federal expenditures over the long sweep of our nation's history conveys both a lesson and a warning. These expenditures first reached the \$100 billion level in fiscal 1962, or nearly 200 years after the founding of the republic. By fiscal 1971, or nine years later, spending had risen another \$100 billion and thus passed the \$200 billion mark. And the \$300 billion mark will surely be exceeded this fiscal year unless the Congress and the Administration move at once to prune expenditures.

One result of the sharply rising trend of Federal expenditures is that government has been assuming an ever larger role in the economic life of our people. Where the line can be best drawn between public and private use of resources is, of course, a matter of judgment and of social values. Nonetheless, it should be clear to everyone that Federal spending, whatever its level, needs to be financed on a sound basis.

Deficit spending by the Federal Government can be justified at a time of substantial unemployment. It becomes a source of economic instability, however, during a period of exuberant activity -- such as we have experienced in recent years. The huge and persistent deficits of the past decade added enormously to aggregate demand for goods and services, but they added little to our capacity to produce. They have thus been directly responsible for a substantial part of the inflationary problem.

The current inflation began in the middle 1960's when our government embarked on a highly expansive fiscal policy. Large tax reductions occurred in 1964 and the first half of 1965, and they were immediately followed by an explosion of Federal spending. New and substantial tax reductions occurred again in 1969 and 1971, and they too were followed by massive increases of expenditures.

Deficits have therefore mounted. In the last five fiscal years, that is, from 1970 through 1974, the public debt -- including obligations of the Federal credit agencies -- has risen by more than \$100 billion, a larger increase than in the previous 24 years.

In the fiscal year just concluded, the reported budget deficit declined to about \$3-1/2 billion. This was a much smaller deficit than in the three preceding years. But when off-budget outlays and

the expenditures of governmentally-sponsored agencies are taken into account, as I believe they should be, the total Federal deficit reached \$21 billion last year, which is not much lower than the corresponding deficits of the three previous fiscal years. This is a sorry record of fiscal policy during a period of sharply rising prices.

Our people have understandably become impatient, and the Congress has reacted by setting in motion revolutionary changes in its budgetary procedures. What fiscal steps and other measures will prove most constructive in current circumstances, when our nation is threatened by increasing unemployment as well as by galloping inflation, cannot be foreseen with any precision. But the general direction for public policy seems clear to me, and in any event it is my duty to share my thinking with your Committee.

First, a policy of moderate monetary restraint remains appropriate, and it will probably be required for a considerable time. As you know, the Federal Reserve has been pursuing a policy of slowing down increases of money and credit. We have tried to apply the monetary brakes firmly enough to get results, but we have also been mindful of the need to avoid a credit crunch. Thus, the supply of money and credit has continued to grow, although at a slower pace than in recent years.

The narrowly-defined money supply -- that is, currency plus demand deposits -- has expanded so far this year at an annual rate of 5-1/4 per cent, in contrast to 6 per cent during 1973. If the time deposits of commercial banks, except for their large certificates of deposit, are also included in the money supply, the rate of growth thus far this year has been 8 per cent, in contrast to 9 per cent during 1973.

Clearly, the American economy -- taken as a whole -- has not been starved for funds. Yet, the demand for money and credit has been rising at a very much faster pace than the supply. As a result, credit markets have become strained and interest rates have risen to levels such as we have not previously known in over a century of our nation's recorded experience.

The policy of monetary restraint pursued by the Federal Reserve has helped to cool the economy by moderating the expansion of credit and disciplining inflationary psychology. But, as you know, the incidence of monetary policy is uneven. Excessive reliance on monetary restraint leads to unwanted side effects that, of late, have been all too evident. The fabric of our financial structure has perhaps been stretched as much as it safely can.

The Federal Reserve must -- and will -- persevere in the fateful struggle against inflation. But I also believe, and more strongly with each passing week, that monetary policy should not carry so large a part of the burden of restraint.

The second ingredient of an effective anti-inflation program, and one that is urgently needed, is a persuasive move toward fiscal restraint on the part of the Federal Government.

Full implementation of the new budgetary procedures for which this Committee is responsible will not begin for two more years. We dare not wait that long, however, for the fiscal discipline required in the present inflationary environment. A determined effort should be made immediately to pare budget expenditures in fiscal 1975 and to balance the budget in fiscal 1976.

I recognize that this Committee is not yet in a good position to recommend where expenditure cuts would be most appropriate. Nevertheless, you can justly use your good offices to press for prompt action to restrain Federal spending.

A meaningful cut in Federal spending -- say, a reduction of 5 or even 10 billion dollars in this year's budget -- cannot be expected to have a large, visible impact on the price level in the near future. But it is highly important to recognize that the effects of a given act of fiscal restraint on prices will cumulate as times move on; that if

this year's fiscal restraint is repeated next year and the year after, the cumulative effects will swell; and that once a determination to cut the budget back is demonstrated, beneficial effects on both the stock market and interest rates can come rather promptly.

Let me turn next to a third ingredient of a program for regaining general price stability. While effective monetary and fiscal policies are absolutely essential to this objective, an incomes policy that relies on voluntary cooperation can still play a modest -- but useful -- contributory role. There is much good will among our citizens, and it would be wise to mobilize it in the struggle against inflation.

The newly established Council on Wage and Price Stability is a step in the right direction. Even without enforcement powers, this agency can hold hearings on wage and price changes in pace-setting industries; it can make recommendations; it can call attention to abuses of economic power by business firms or trade unions; it can feel its way toward wage and price guidelines; and it can certainly bring the force of public opinion to bear on wage or price changes that appear detrimental to the national interest.

A Labor-Management Committee, under the chairmanship of the President, might become another constructive force. Labor and management clearly have a mutual interest in ending inflation. If our nation's business and labor leaders will meet frequently and

reason together, practical means may yet be found to interrupt the cycle of wage, cost, and price increases that is so damaging to our economy.

As a fourth part of an anti-inflation program, our nation needs an energy policy -- as President Ford has emphasized -- that will exert downward pressure on the international price of crude oil. Some success in this direction would not only help to check inflation, it would also reduce the massive diversion of purchasing power to oil-producing countries, and make the problem of recycling funds to the oil-consuming countries more manageable.

Since the end of the oil embargo, efforts to conserve fuel have diminished. Our electric lights are again blazing away needlessly; the 55 mile per hour speed law is less rigorously enforced and gasoline consumption is rising; air conditioners hummed excessively this summer and our heating furnaces will probably soon be. Clearly, voluntary efforts to conserve fuel and broaden the use of fuel-saving devices need to be strengthened. Legislative actions should also be considered, particularly tax measures aiming to curtail the consumption of oil and gasoline.

We cannot stop, however, with conservation measures. For one thing, it is necessary to breathe life into Project Independence before it expires from inactivity. This will require, among other

things, reduction of obstacles to the expansion of nuclear facilities by our electric utilities, and sufficient relaxation of anti-pollution regulations to encourage much more extensive use of coal. And in view of the extraordinary financial problems caused around the world by OPEC actions on oil prices, we cannot afford to lose time in exploring with other major oil-importing countries how economic, financial, and political measures can be most effectively used to achieve an early and substantial reduction in the price of crude oil.

A fifth part of an anti-inflation program should focus on policies for enlarging our productive capacity and intensifying the forces of competition. Incentives to invest have not been adequate in recent years to keep industrial capacity expanding in step with our economy's needs, and this requires the most earnest attention of policy makers.

A strengthening of equity markets through liberalization of the capital gains tax would be helpful in providing share capital at a more reasonable cost. This could probably be accomplished without impairing tax revenues this year. Moreover, business firms themselves could gradually increase the supply of internal funds for investment by adopting more realistic and sensible accounting procedures. Many firms fail to value the inventories used up in the production process on a replacement-cost basis, with the result that earnings are overstated and taxes are paid on fictitious profits.

Our capacity to produce could be enlarged by establishing local productivity councils to increase efficiency in our nation's workshops. It could also be enlarged by removing obstacles to supply that are sanctioned by legislation or custom. For example, building codes in many communities are badly outdated; minimum wage laws restrict access to jobs by teenagers; and barriers to entry or governmental regulation restrict output in some of our industries. Our product markets could be made more competitive by stricter enforcement of the anti-trust laws, by stiffer penalties for their violation, by repeal of special-interest legislation such as the Davis-Bacon Act and the Jones Act, and by passage of the proposed Trade Reform Act. And our labor markets could function better if we developed a nation-wide system of job banks, comprehensive statistics on job vacancies, and adequate manpower training programs.

Sixth, and finally, an anti-inflation program should recognize that restrictive monetary and fiscal policies have uneven effects on the economy -- that some sectors are merely inconvenienced, but that others suffer hardship. Homebuilding, in particular, is highly sensitive to money market developments, as the drastic decline of housing starts has once again demonstrated. Basic reforms of home mortgage finance are essential, so that homebuilding activities may be more stable in the future. Meanwhile, another layer of governmental subsidy for this stricken industry may be urgently needed.

It would also be wise to provide promptly for a public service employment program that would be triggered if and when the national unemployment rate averaged more than 6 per cent for a three-month period, and that could provide up to 800,000 jobs at a cost that might reach, say, 4 billion dollars. A contingency plan of this type would reduce fears of unemployment. It would be practical as well as compassionate; for it would enable the Federal Government to continue longer with the restrictive monetary and fiscal policies that are needed to bring inflation gradually under control.

In the interest of fiscal discipline, the funds that would be required to expand public service employment, as well as any additional housing program, would have to be found in large part, if not entirely, by cutting expenditures elsewhere or by making minor additions to tax revenues.

In sketching this six-part program, I have sought to suggest that this country needs a broad and eclectic approach to the inflation problem; that restrictive monetary and fiscal policies are basic but insufficient; that they can be usefully supplemented by incomes, energy, and supply-expanding policies; that measures are also needed to alleviate the harsh impact of a policy of monetary and fiscal restraint on some sectors of our economy; and that long-range as well as immediate considerations require attention. I hope that the Congress will recognize

general price stability as a prime objective of public policy by promptly passing a concurrent resolution to that effect, and that you will then turn to exploring in detail the numerous thoughtful suggestions that are emerging from the "summit meetings."

Your Committee's efforts to restore order in Federal finances can make the difference between success and failure in the fight against inflation. I assure you that the Federal Reserve will do everything it can to facilitate your task.

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