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Statement by

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before the

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I am glad to have the opportunity to present to this Committee the views of the Board of Governors of the Federal Reserve System on the state of the economy.

I would like to begin by reviewing the progress made during 1969 in combatting the inflation that has been so damaging to our economy and to our international balance of payments during recent years.

### Progress in 1969

A year ago the prevailing view of the public--and especially of the business and financial community--was that the Administration and the Congress lacked the will to pursue fiscal restraint with sufficient vigor to accomplish lasting results. The income tax surcharge, it was assumed, would not be extended beyond mid-1969. More importantly, perhaps, it was widely believed that when fiscal 1970 began the gates would be opened to a new flood of Federal spending that might engulf the economy once more.

In the monetary field, we faced a similar problem. The financial community was inclined to assume that monetary restraints of any real significance would last only a few months--that the Federal Reserve would lose courage and begin to back off at the first signs that financial restraints were beginning to bite.

These expectations of an early resumption of inflationary policies, however, were not fulfilled. On the contrary, the Congress, the Administration, and the Federal Reserve demonstrated by their actions during the past year that they were willing to apply the restraints needed to bring inflation under control. The Administration asked for, and ultimately obtained, extension of the income tax surcharge at 10 per

cent through the end of the year and also a repeal of the investment tax credit effective April 21. The growth of Federal expenditures was kept down. Between the fourth quarter of 1968 and the fourth quarter of 1969, total Federal spending, as recorded in the national income accounts, increased only half as much as it had in the previous four quarters. As a result of these measures, we were still enjoying a surplus in the Federal budget at an annual rate of about \$7 billion during the latter half of last year.

In the field of monetary policy, the view that financial restraints would last only a few months also proved to be wrong. Monetary restraint intensified during the year, as the Federal Reserve modified its open market policies and regulations, thereby limiting the growth of the money supply and the provision of credit through the banking system. By the last half of 1969, growth of the money supply had virtually ceased. And the growth of bank credit--even including all of the funds that the banks were able to obtain from such nondepository sources as borrowing in the commercial paper market and in the Euro-dollar market--had slowed to an annual rate of less than 3 per cent.

Thus, great strides were made in 1969 towards demonstrating the government's determination to follow an effective economic stabilization policy. But we accomplished more than this, too. As the year unfolded, evidence accumulated that the growth of total spending was finally slowing down. By the second quarter of 1969, a new mood of caution gripped consumers, and retail sales began to show signs of weakness. In the durable goods area, particularly, sales declined in the late summer

and autumn to the point where substantial cuts in production of autos, appliances, and other consumer durables became necessary. Output of defense equipment began to drift off in the spring months and to decline sharply in the summer, when total Federal employment also began to contract. The availability of mortgage credit declined substantially, despite massive funds poured into the mortgage market by FNMA and the Federal Home Loan Banks, and housing starts fell to an annual rate of 1.3 million by the fourth quarter--one-fifth below the year-earlier level. Many State and local governments, meanwhile, found credit so difficult to obtain and so costly that they were forced to curtail their planned capital outlays.

The effects of monetary restraint last year--though uneven--were not, however, confined to housing and to State and local construction. Many businesses, including even some very large firms, were unable to raise the funds on which they had counted. Furthermore, the protracted decline in the bond and stock markets strongly affected expectations as well as asset values, and may well have been an important factor in the conservative spending patterns of consumers.

The results of our monetary and fiscal restraints showed up most clearly in the moderating pace of the major indicators of aggregate economic activity. Industrial production began to decline last August and has continued to fall since then. The markets for labor likewise began to ease in the summer, and by the late fall and early winter months the more sensitive measures of labor market conditions were pointing to reduced demand pressures. By the fourth quarter of last year, the expansion in our nation's total output of goods and services apparently came to a halt, and this January the unemployment rate again approached 4 per cent.

Regrettably, these evidences of cooling in the economy have not yet been reflected in a moderation of prices. I hope, however, that disappointment about the recent performance of wholesale and consumer prices will not distort our judgment. We need to bear in mind that the response of costs and prices to changes in the underlying balance between demands and supplies entails a process that takes a considerable period of time. Businesses continue to be faced with rising costs as economic growth slows, since productivity gains typically are depressed while wage increases remain large for a time. The response of business firms in these circumstances is often to test their product markets by passing on rising costs in the form of higher prices, but then to back away from list prices when the volume of sales begins to decline. Such discounts from list prices are not fully reflected in our price indexes which may, in the early stages of disinflation, continue to register unusually large increases, as they have recently. Eventually, however, list prices, too, will begin to give way under the pressure of increased competition; and as the easing in prices at the wholesale level carries through to the consumer level, the prospects for more moderate wage settlements are enhanced.

The lags involved in this process are long, and they are likely to be longer the more deeply entrenched are the inflationary expectations. We are paying the price now for letting inflationary developments build up a head of steam over the past five years. By the end of 1969, however, we had succeeded in eliminating the excess demand for goods and services that has been at the root of the inflationary problem. We must now have the patience to wait for the improvement in price performance that will eventually result.

In the international field, we also began to make some progress last year toward improving our fragile trade balance. Once the effects of the dock strike were over, exports responded to rising demand abroad, while the dampening of excess demand in the U. S. slowed the rate of increase of our imports. Nevertheless, our overall balance of payments registered a heavy deficit on the liquidity basis--as other components of the accounts worsened, especially the outflow of U. S. private capital. Financing of the deficit was mainly accomplished by enormous borrowings in the Euro-dollar market by U. S. banks. I should add, and if time permitted I would give emphasis to the fact, that a very significant improvement in the stability of the international monetary system occurred last year, as some necessary exchange rate adjustments were made, as the issuance of SDR's was agreed to, and as the status of gold was stabilized.

While we can take some satisfaction from the changes in our international accounts and in international financial arrangements during 1969, we need to recognize that the condition of our balance of payments still remains very unsatisfactory. The need to restore a reasonable surplus in our trade with other countries reinforces the domestic reasons for making sure that inflation subsides.

#### Expectations for 1970

Let us turn now to the year ahead. What can we reasonably expect and hope for in the fight against inflation during 1970? We must, of course, be realistic. The battle against inflation is not over, and further adjustments must be made to regain a path of sustainable noninflationary growth. There is now room for substantial optimism on this score, given the progress already made.

We must also be realistic about our ability to forecast economic developments. The uncertainties are especially large in a period of transition such as we are now experiencing. On the one hand, there is still the possibility that the cooling off process will be cut short, and that longer-run inflationary expectations will thereby be reinforced and intensified. But there is also the possibility that the recent weakening tendencies in the economy will persist and intensify, delaying the time when a satisfactory rate of growth will be resumed.

In a situation like the present, we must therefore be especially alert to new and unexpected developments. With this reservation, it seems to me that the projection of the gross national product for 1970 presented by the Council of Economic Advisers is a reasonable one, in terms of what is both achievable and desirable. The Council has projected a period of little economic growth early this year, followed by moderate expansion thereafter. The Board of Governors also expects to see a resumption of growth in total real output and in industrial production before too long. But no one should be surprised if the sluggish pace of total spending that developed in the fall and winter months of 1969 continues for awhile.

In the home building industry, some further decline in housing starts appears likely, in view of the current state of the mortgage market and the lag with which changes in this market affect construction. For State and local governments, also, funds have been exceptionally scarce and expensive in recent months, and the postponements and stretchouts of projects that have already occurred will continue to affect activity in the months ahead. We may also see some retrenchment in the rate of

inventory investment early this year. At present, stocks of durable goods are rather high in relation to sales, and efforts to bring stock-sales ratios down, already underway, could well continue. Defense spending, furthermore, is moving downward, and substantial additional cutbacks are scheduled for 1970, reflecting both reduced purchases of defense goods and a decline in the size of the Armed Forces.

Prospective weaknesses in these areas, however, will tend to be offset by elements of strength in other sectors of the economy. Business investment in plant and equipment has been growing at a rapid pace, and various surveys point to substantial further increases in the near term. Furthermore, the demand for consumer goods is likely to be shored up by the rise in disposable income that will accompany the phasing out of the surcharge by midyear and the second quarter increase in social security benefits.

If events develop along these lines, we would be setting the stage for the resumption of sustained economic expansion later this year. Furthermore, that expansion would, I believe, display a better distribution of output in two respects. First, over this past half year, retail sales--in real terms--have actually declined, while businesses have continued to add substantial amounts to plant capacity. If this imbalance continued through 1970, it would be a matter of real concern. However, as the year progresses, retail sales are likely to pick up, while the expansion of business investment in new plant and equipment tapers off in response to the cost-price squeeze in which business is now caught. Second, if economic developments proceed as outlined above, we would have both the real and the financial resources later this year for the resumption of growth in homebuilding which is so vital to the welfare of our society.

There has been considerable concern in some quarters that the economy during the second half of this year is likely to experience such a vigorous rebound as to destroy our chances of getting inflation under control. With the release early this month of the Administration's Budget, some of the fears expressed earlier have been quieted. We are all aware, of course, that budget expectations and budget results are often at variance. However, if the degree of fiscal stringency called for in the Administration's Budget is realized, the resumption of economic growth we are looking forward to later this year will not, I believe, be excessively rapid. Instead, we should find that the pace of economic expansion stays well within the bounds of our resource capabilities, and that a gradual process of disinflation continues throughout the year.

I wish I could assure this Committee that the disconcerting advance of the consumer price level will soon come to an end. Unfortunately, such optimism is not warranted. This year there will be wage contract negotiations in a number of major industries. Workers will be striving to obtain wage increases large enough to permit some improvement in their standard of living besides making up for the erosion in real earnings caused by inflation during recent years. These negotiations will take place in an atmosphere in which product markets are more competitive and business profits are being squeezed. Employer resistance to inflationary wage contracts will therefore be larger than in recent years. Nevertheless, it seems evident that negotiated contracts will provide for wage increases exceeding the growth rate of productivity, so that unit labor costs will still be rising. We should not, consequently, expect an end to inflation this year, but we can look forward to a progressive moderation in the rate of price advance.

Such a course of economic developments in 1970 would provide an opportunity for improvement in our balance of international trade. The readjustments of the economy in the first half of the year should help to hold down the rise in imports. On the other hand, with strong expansion continuing in Europe and Japan, our exports should fare reasonably well. Our trade balance would thus be showing a gain over the depressed level of the past two years, but there would still be ample room for future improvement.

Unfortunately, these gains in our trade account could be cancelled by adverse flows of capital, so that our balance of payments would continue to suffer. Larger outflows of U. S. capital may occur if credit conditions in our country become markedly easier than in other industrial countries. Moreover, U. S. companies appear to be planning larger outlays for foreign plant and equipment this year. Our balance of payments accounts on the official settlements basis will also be affected adversely if--as now seems likely--the large inflow of Euro-dollars to U. S. banks that occurred last year is reversed or even reduced.

#### Implications for Monetary Policy

Let me now turn to monetary policy and its role in assuring that the gradual diminution of inflationary pressures anticipated for 1970 becomes a reality.

Monetary policy moved progressively, in the course of the past year, to a posture of severe restraint--virtually halting the growth of the money supply and putting an extremely tight rein on the ability of banks and other financial intermediaries to finance the nation's economic

needs. From the perspective of history, we know that a policy of such severity could not and should not be continued indefinitely. Quite apart from the cumulative effects of such a policy on aggregate demand, its uneven impact on key sectors of the economy would become intolerable. The continuation of such intense monetary restraint for any extended period would threaten marked further declines in home building and in State and local government activities, and would increasingly dry up the sources of finance for small and medium-size businesses that are not able to tap the public capital markets.

As we all recognize, monetary policy must stand ready to adapt quickly to unanticipated developments in the economy and in financial markets. At the present stage of our battle against inflation, this principle has particular force. The Board cannot overlook the possibility that the present slowdown in economic activity, which is a healthy development, may yet be followed by a recession. Monetary policy might have to change quickly if that risk should become larger. There is also the possibility, however, that the inflationary processes with which we are dealing may prove more stubborn than we realize. If too vigorous a rebound in the total demand for goods and services were to occur later this year, as was the case in late 1967 and early 1968, we could lose the battle against inflation that the combined forces of our government have so courageously fought.

For some time this year, our monetary and credit policies are therefore likely to tread a narrow path between too much restraint and too much ease, as we go through the transition from an overheated economy

to a path of noninflationary growth. As I indicated in my testimony to the House Banking and Currency Committee earlier this month, a tight rein on Federal expenditures, as called for in the Administration's Budget for fiscal 1971, would lay the basis for moderation in overall credit conditions. I may add here that if the economy follows the course that I have outlined and a diminution of inflationary pressures is realized, monetary policy could well move as the year progresses towards a posture more nearly in keeping with our economy's long-run needs for money and credit. And, as inflationary expectations abate, we should see a significant reduction in the overall tensions in credit markets, one aspect of which would be a downward movement of interest rates toward historically more normal levels.

I trust that the Committee will understand why it would be difficult, if not improper, for me to present a more precise projection of the monetary outlook. Despite centuries of disinterested thought and inquiry, the role of monetary variables in economic activity and in prices is still subject to troublesome margins of uncertainty. I can perhaps best illustrate this point by reference to the projections of GNP and financial flows that were presented by the Board's staff to this Committee a year ago. Looking back at those estimates, you will find that the actual growth of the dollar value of our nation's total output in 1969 proved to be in excess of the amount projected. So also was the level of private borrowing. On the other hand, the actual rates of growth of bank reserves, the money supply, commercial bank time deposits, and bank credit during 1969 were all below the lower limits of the projected ranges. For example, the Board's staff a year ago projected a growth rate of the money supply in the range of 3 to 6 per cent. The actual increase was 2-1/2 per

cent. Time deposits at commercial banks were projected to increase within a range of 1 to 5 per cent. In fact, these deposits declined by 5 per cent.

I do not cite these statistics by way of criticism of the Board's staff, which I hold in the highest regard. The nub of the matter is that the financial restraint needed to keep inflation from getting out of hand last year proved to be much greater than almost anyone had estimated, and the monetary authorities therefore found it necessary to follow a highly restrictive course.

The release of those projections a year ago helped to foster the mistaken judgments, which I mentioned earlier, that the Federal Reserve planned only a brief period of monetary restraint. As a result, commercial banks and other lenders were more willing to make loan commitments to businesses, and the effects of monetary restraint on business spending were delayed. Our effort to get inflation under control was therefore hampered. I do not think this Committee would like to see such a misadventure repeated.

The Board is watching very closely developments in the economy during this difficult period of transition. I assure this Committee that the Federal Reserve will do everything in its power to prevent a recession. Large backlogs of demand have been built up in important sectors of the economy, so that total spending can be expected to respond with speed and vigor to monetary stimulus. But I also want this Committee to know that the Board is determined not to forsake the present opportunity to obtain control over inflationary pressures.

A Longer-Range View of Stabilization Policies

Before closing, let us look ahead briefly to the challenges and the opportunities of the decade just beginning. Our recent overriding problem, of course, has been to deal with inflation. In longer-range planning, our national attention has tended to shift from a focus on economic growth to a concentration on reevaluating our national priorities for resource use. This shift in emphasis in longer-range planning was badly needed. But we cannot overlook the fact that the economic and social problems of this country will be more readily resolved if our resources are utilized in ways that maximize the long-run potential for economic expansion.

The potential for economic growth and prosperity over the next decade is, it seems to me, enormous. In just the last five years, over \$100 billion has been spent for research and development carried out in the private sector. Surely, this is the very foundation of economic growth--the new ideas, the new products, and the new processes that innovations, embodied in a growing stock of machines and industrial plants, make possible.

Demographic factors will be working in our favor during this decade. Projections by the Bureau of Labor Statistics suggest that growth in the labor force will be even more rapid in the 1970's than in the 1960's. The composition of the increase in labor force will also be favorable to economic growth, since the proportion of adult males in the total expansion is expected to rise appreciably. Steady increases in the number of young adults in the labor force should provide employers with a pool of more highly trained and dependable workers.

Productivity increases should quicken, because these additional workers will be better educated than their predecessors and will be provided with more machinery and equipment in handling their jobs than previously.

There is little reason to expect that deficiencies in demand will keep us from enjoying the fruits of our enhanced capacity to produce. Growth in demand for goods and services will continue to be supported by an ever-increasing population, even if birth rates continue the downtrend of recent years. In addition, the age distribution of our population assures a substantial increase in the number of new households, with accompanying large needs for housing, for schools, and for a wide variety of services requiring massive capital expenditures by State and local governments. Indeed, outlays on housing must rise substantially just to make up the deficiency that has accumulated in recent years.

There is no automatic assurance that we will enjoy all of the potential benefits that these opportunities present. The challenge that faces us now, in the area of stabilization policy, is to see whether we can learn from the experience of recent years--whether we can devise the means to avoid inflation and to maintain the rapid economic growth which our resources make possible.

On the fiscal side, the most obvious and pressing need is to avoid the disruptive changes in the level of Federal expenditures that give rise to huge budgetary deficits, to inflation, and to misallocation of resources. If sharp increases in high priority outlays are required, as may happen, other Federal expenditures must be curtailed through a reordering of priorities, or offsetting adjustments in taxes must be

considered immediately. Discipline will also have to be maintained to avoid wasteful use of resources in outmoded programs. We must, I believe, anticipate that the resources utilized for new Federal programs--of which there are likely to be many in the years ahead--will have to come principally from discarding old programs or from the revenue increases that normally accompany economic growth.

In our search for fiscal stability and efficient use of resources at the Federal level, we cannot concentrate simply on activities that register their effects in the budget totals. It will be necessary to maintain a watchful eye on the lending and borrowing programs of government-sponsored agencies, and also on the growing volume of government guaranteed credits--both of which go on outside of the budget. The programs of these agencies have a legitimate and important role to play in a competitive economy. They improve the functioning of our financial markets by absorbing risks that private markets do not now assume. They facilitate credit flows to sectors of high social priority that for one reason or another cannot adequately compete in private financial markets. They help to buffer the effects of financial restraint on the housing market. Nonetheless, these programs, too, must be carefully scrutinized because of their impact on resource utilization and aggregate demand.

In the monetary area, one of the important considerations for future policy will be to determine the appropriate range of variation in the major monetary and credit aggregates. This Committee has expressed its concern repeatedly that monetary policy has permitted excessively wide variations in the growth rates of money and bank

credit. Let me assure you that the Board shares your concern on this matter. We have lived through a period in which the disadvantages of marked changes in the degree of monetary restraint or ease have been all too evident. We are well aware that monetary policy works in complex ways, with lagged effects that are difficult to predict as to timing, magnitude, and sectoral impact. Certainly, if fiscal policy makes a more positive contribution to economic stability in the years ahead, wide variations in the posture of monetary policy would be less appropriate.

If monetary policy is to make a better contribution in the future to economic stability and a proper distribution of resources, we must do more than merely adjust our policies in ways that alter the growth rates of the monetary aggregates. We must find the means to reduce the uneven impact of monetary restraint on such sectors as housing and State and local governments. I do not come here today with solutions to offer, but I can assure you that the problem will be under intensive study in the Federal Reserve.

Finally, it seems to me that our policies will need to be directed towards promoting a greater adaptability of all of our financial institutions to changes in financial markets and in the needs of the economy. Our financial institutions have shown an extraordinary ability to innovate and adapt, but more recent developments have suggested that more still remains to be done in this regard. We will need to reconsider our regulatory devices and procedures in light of the way financial flows have been affected in recent years.

The decade just closed might well go down in history as marking the renaissance of central banking. We rediscovered how terribly important monetary policy is to the health of our economy, and the need for a proper balance of monetary and fiscal actions to promote our national economic objectives. We also learned that we knew less about the workings of these policies than we had supposed. We must now move forward rapidly to begin closing the wide gaps in our knowledge if we are to fulfill the promise of the years ahead.