Federal Reserve System

Speeches Burns

For release on delivery

Statement by

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Committee on Banking and Currency

United States Senate

March 18, 1970

I am pleased to be here today, representing the Board of Governors of the Federal Reserve System, to discuss with this Committee the current condition of our national economy.

I shall begin by reviewing recent economic trends, then report on progress in our governmental efforts to regain a path of noninflationary growth, and close by noting the tasks that lie ahead for monetary and fiscal policy.

Recent Developments

As this Committee knows, our nation has been wrestling for several years with a very serious -- indeed, a dangerous -- problem of inflation. Measures of fiscal restraint were needed and were finally taken in a series of actions that began with passage of the Revenue and Expenditure Control Act of 1968. These measures were later supplemented by stern monetary actions, and they have together served to retard the growth of total spending.

In the early stages of our restrictive policy, adjustments in the pace of activity were confined to a relatively few industries -- principally, construction and defense production. Last summer, however, consumer spending on durable goods weakened and output in the affected industries soon began to decline. In the autumn, many firms that supply equipment or materials to the construction industry, to producers of defense goods, and to manufacturers of consumer durables found their orders and sales falling below their earlier pace, and they too began to cut back their production.

As is usual in periods of economic slowdown, retrenchment in the industrial sector has been substantially greater than in the economy as a whole. Total output of goods and services continued to rise in the third quarter of 1969 and then flattened out in the fourth. Industrial production, on the other hand, began to decline in August, and in the fourth quarter averaged about 1-1/2 per cent below the third quarter level. In the first two months of this year, declines in industrial production continued and became somewhat more general. Cutbacks of production spread to nondurable goods, the length of the workweek in manufacturing declined sharply, and the unemployment rate rose to 4.2 per cent.

In short, a number of important economic indicators have been pointing downward recently, thereby giving rise to concern that the corrective measures taken by the government may go too far and perhaps lead to a business recession. At the Board, every piece of incoming information is constantly reviewed and weighed with care. Based on our analysis of ongoing and prospective developments in key sectors of the economy, it is still our view that the current economic adjustment lacks the pervasive and cumulative characteristics of a recession, and that in any event the economy will resume its upward course later this year.

Defense Expenditures

Let me begin by considering the role of defense expenditures in the adjustment currently in process. Large increases in outlays for defense from mid-1965 until the latter part of 1968, when the Federal budget was badly out of balance, were one of the major sources of inflation during recent years. More recently, with better fiscal management and gradual de-escalation of the Vietnam conflict, the defense budget has ceased to be a stimulating factor in the economy.

New orders from the U.S. Government to the aerospace industries began to taper off early in 1968. Later that year, output of defense equipment began to decline, and it has continued to fall since then, During 1970, total defense expenditures will average about 6 per cent below the 1969 level, if the Administration's budget is realized.

The turnaround of these expenditures has played a vital role in helping to slow the growth of aggregate demand for goods and services. Our hopes for getting inflation under control, and for making resources available to meet other national objectives of high priority, have been appreciably enhanced thereby.

In the near-term, defense expenditures will be exerting a further downward influence on the economy. However, other Federal expenditures are scheduled to rise, and they will more than offset the decrease in defense spending.

Consumer Durables

Though we should expect the decline in defense production to continue, there is reason to think that the adjustments which got underway last summer in another major sector of our economy -- the consumer durable goods trade -- may already be in large part behind us. The volume of consumer purchases of durable goods began to diminish in the late spring of 1969, and the rate of retail inventory accumulation began to rise rapidly during the late summer months. Producers reacted promptly to avoid a buildup of undesired inventories. Between July 1969 and January 1970, the output of automobiles declined about 25 per cent, and production of durable household goods fell nearly 10 per cent -- in the latter case, partly because of strikes in the electrical equipment industry. Last month, further reductions occurred in the production of automobiles and some other consumer durables.

The recent decline in the output of consumer durables has exceeded by a considerable margin the decline in consumer purchases. As a consequence, we have already seen evidence that excess inventories are being worked off. Retail inventories of autos, after seasonal adjustment, declined in December and retail inventories of other durables stopped rising. Preliminary figures indicate that retail inventories declined during January in both of these categories.

The reestablishment of balance between production and sales has thus been proceeding smoothly for consumer durables. Furthermore, the prospects seem favorable for an early pickup in buying, since consumer incomes will be bolstered by a rise in social security benefits beginning in the second quarter and by the removal of the remaining income tax surcharge at midyear.

The consumer durable goods sector is now exercising less drag on the economy than in the recent past, and it could well become a source of stimulus. Auto production schedules already have been increased moderately this month, and we may also see a resumption of somewhat higher production rates for other durables in the second quarter.

Residential Construction

I wish it were possible to be equally optimistic for the near term about homebuilding. The February upturn in housing starts, while encouraging, is of doubtful significance. Recent trends in building permits and in the volume of outstanding mortgage commitments of private financial institutions suggest that housing starts may decline somewhat further in the months immediately ahead.

There are grounds for believing, however, that some improvement in the trend of homebuilding will begin this summer. Underlying demands for housing space are intense, and a resurgence of starts and construction will take place when mortgage funds become more readily available. Conditions in the credit market are now moving in that direction. Yields on short-term market securities have declined substantially from earlier peaks, and banks and other depositary institutions now can pay higher interest rates on time and savings deposits. Consequently, we may soon see a notably larger flow of savings to banks and thrift institutions. In recent weeks, a renewed inflow of time and savings deposits has already begun to develop at the Nation's commercial banks. Preliminary data suggest, moreover, that outflows from savings and loan associations and mutual savings banks have ended, and that there may even have been a small inflow of deposits to these institutions in February.

Financial institutions must commit funds to builders well in advance to ensure full participation in the financing later on of a housing recovery. Mortgage lenders are aware of this, and some are already reevaluating their commitment policies in light of their expectation of renewed strength in home construction later this year. Others will be following their example.

Business Capital Outlays

Another major sector of private expenditures that will play a key role in economic developments this year is business spending for new plant and equipment. These outlays continued to rise at a rather rapid pace in the second half of last year, and a further increase is in prospect for 1970. However, the magnitude of the increase may be overstated by recent surveys of business plans.

The most recent governmental survey of capital outlays suggests that since late last fall there has been some strengthening in the expenditures planned by business firms -- especially, the expenditures planned for the second half of this year. Private surveys have been pointing in the same direction. But we know from past experience that downward revisions in capital expenditure plans often occur when the economy is in process of transition, as it is now. In each of the past three periods of economic sluggishness -- in 1967, 1960, and 1958 -- actual expenditures for plant and equipment fell short of the anticipations reported early in the year.

Moreover, some indicators of plant and equipment spending are even now pointing downward. New orders for machinery and equipment fell significantly in December and January, and new capital appropriations by large manufacturing firms declined in the fourth quarter of last year.

As I interpret the somewhat contradictory indicators of activity in this sector, further large increases in outlays for plant and equipment seem likely during the first half of this year. Order backlogs for capital goods are still sizable, and a significant part of the increase in planned outlays for early 1970 is in the public utilities and communications industries, where pressures on available capacity are being felt. In these industries, capital spending programs are not likely to be revised downward. As the year progresses, however, further narrowing of profit margins and a rise in idle capacity are likely to convince an increasing number of manufacturing firms that stretchouts or postponements of capital expenditure programs are in order. Business capital investment will nevertheless remain at a very high level throughout this year.

Implications for 1970

Let us now consider how developments in the several sectors on which I have focused may interact to shape the course of overall economic activity during the remainder of 1970. Although the state of our knowledge does not permit precise forecasts, I think some tentative conclusions can be drawn from the interplay of economic forces presently at work.

We must be prepared, it seems to me, for some relatively unfavorable economic news in the weeks ahead. Housing starts may fall further. In some durable goods lines, efforts now underway to bring inventories into better balance with sales and orders could lead to a further decline in manufacturing output. Defense expenditures will be declining. State and local construction outlays may show little growth until later this year, since the near-term trend in these expenditures will continue to be affected by the extremely tight conditions that prevailed until quite recently in the market for State and local government securities.

The adjustment now underway, however, does not seem to have the pervasive or cumulative characteristics that mark a business recession. A basic feature of historical recessions has always been a decline in expenditures on business plant and equipment; in the months ahead, however, these expenditures will almost certainly be rising. Besides, production of consumer durable goods may start increasing fairly soon — if, as seems likely, there is some pickup in consumer buying this spring. Consequently, while a sluggish pace of economic activity may continue a while longer, it seems reasonable to expect a resumption of economic growth in the relatively near future.

If this judgment is correct, the adjustment we are now experiencing will prove to be a healthy one. It will set the stage for a more balanced economic expansion beginning later in the year -- an expansion in which housing, State and local construction, and consumer buying will all participate. And most importantly, the adjustment will have established the necessary conditions for a moderation of the rise in wholesale and consumer prices.

Prices

There is no longer any doubt that, taking economic activity in the aggregate, excess demand has been eliminated. So far, however, there has been very little hard evidence that price pressures are easing. Indeed, the rate of price increases late last year seemed to be accelerating while the pace of economic activity was weakening. Consumer prices rose this January as much as in December, and the rise in wholesale prices was even larger than in December.

Very recently, however, price developments have offered just the faintest glimmer of hope that the rate of price increase may be in process of decelerating. Wholesale prices in February showed the smallest increase in several months. Prices of farm products rose at about half the rate in the final quarter of 1969, and there is now reason for hope that supplies of some basic farm products will be more ample this year. Especially heartening was the reduced rate of advance which occurred in February in the wholesale prices of industrial commodities.

While these developments are encouraging, we obviously cannot conclude from the evidence of a single month that a significant further reduction in the rate of price advance is just around the corner. The process of unwinding from the intense inflationary pressures that have developed over the past five years is bound to take time. Pressures on costs intensified greatly last year, as the growth of productivity was slowed materially by the overheated condition of the economy during much of the year. The rate of increase in productivity is likely to remain below the long-term trend until economic expansion is resumed. Inflation, meanwhile, has eroded the real earnings of workers, and they will be striving in contract negotiations during 1970 to obtain wage gains large enough to raise their living standards. Unit costs of production, therefore, seem certain to remain under substantial pressure in the next few months.

While there is little basis for expecting an end to inflation this year, there is reason to expect substantial progress in slowing the rate of price increase. Wholesale price trends in February are illustrative of developments which should become more common as the year goes on. Product markets are much more competitive now, because idle capacity has begun to increase and inventories of unsold goods have become more abundant. Markets are likely to remain more competitive all this year. Many businesses will probably find that they cannot pass on cost increases to their customers as readily as before, and selective price cutting will develop as competing firms fight for a larger share of the market. Profit margins will be squeezed further, and employer resistance to large wage gains will intensify. And, as economic growth resumes later this year, the rate of increase in productivity should improve, and this too will temper the rise in unit costs of production.

Past history assures us that market forces will slow the rate of price advance, provided we avoid a renewed outbreak of excess demand for goods and services. I would hope that businessmen and labor leaders will consider very carefully the prospects for labor and product markets as wage and price policies are made this year. The President has requested a postponement of the pay raise for Federal employees from mid-1970 until the beginning of 1971. This courageous proposal for moderation in Federal wage scales is sound in present circumstances, and I urge the Congress to support it. If wage and price decisions in the private sector are made with equal concern for getting inflation under control, the return to a path of noninflationary growth will be greatly hastened.

Balance of Payments

Our concern for reducing upward pressures on prices and costs stems principally from recognition of the damaging effects of inflation on the domestic economy. But inflation also has an important impact on our position in international markets, and this too must be taken into account.

Some observers have been lulled into believing that international aspects of our economy can safely be ignored. They point to the paradoxical situation last year, when the strength of the dollar was unquestioned, despite a record liquidity deficit. But when the structure of our balance of payments and the role of the dollar as a world currency are considered carefully, it becomes entirely clear that there are no grounds for satisfaction with our performance.

The principal features of our balance of payments in recent years are well known. The trade balance has deteriorated. Military expenditures abroad have continued to be a heavy burden. The outflow of private capital has been held in check by governmental restrictions and relatively tight U. S. credit markets. A major and unexpected source of support has come from foreign purchases of U. S. corporate securities and a huge inflow to our banks of foreign liquid funds.

The task of restoring a reasonable trade surplus will not be easy, nor will our military responsibilities abroad quickly diminish. At this time, our credit markets are not tightening relative to those abroad; on the contrary, recent trends have been in the other direction, so that private capital movements may become less favorable to our balance of payments. In particular, we must be prepared for the possibility of a substantial reduction in the debt of U. S. banks to their branches abroad, accompanied by a rise in foreign official dollar holdings.

There are many positive aspects of recent changes in the world's monetary system--the creation of SDR's, the correction of exchange rates that had gotten out of line, the defeat of gold speculation, and the continuing evidence of a cooperative spirit among monetary authorities. But if large U. S. deficits continue, they will put increasing strains on an international financial system that has served us well during the past quarter century. Definite movement toward the objective of noninflationary growth is essential to improve our balance of payments position.

Unemployment

The battle that the Executive Branch, the Congress, and the Federal Reserve have been waging against inflation has not been costless. An economic slowdown means loss of output that otherwise would have been available to help meet private or public needs. It also means jobs lost, and rising unemployment. In the first two months of this year, the unemployment rate rose to the highest level since October 1965. It will probably rise somewhat further before beginning to decline. This is a matter of deep concern to all of us. As I interpret the statistics, however, the nature of current unemployment is sufficiently different from earlier periods of adjustment to warrant notice.

For example, if we go back about a dozen years, we find that the unemployment rate in 1957 averaged 4.3 per cent--close to the February 1970 level. Almost 54 per cent of the unemployed in 1957 were adult males--that is, men who ordinarily have family responsibilities. In February of this year, only 38 per cent of the unemployed were adult males. In 1957, 17 per cent of the unemployed were teenagers; today the figure is 29 per cent. These differences reflect the changing structure of our labor force in recent times. Women and teenagers, who are far more likely than men to be intermittent or part-time workers, now constitute a much larger fraction of the labor force--and an even greater fraction of the unemployed--than in earlier years. The unemployment rate for nonwhite workers, moreover, is not as high now as it was in 1957, though it is still much higher than the rate for white workers.

Much of the recent increase in joblessness has resulted from production cutbacks in manufacturing, and has been concentrated in the auto industry--where, as I noted previously, production schedules for March have been raised somewhat from the low level in February. Many of those who lost jobs have been workers with sufficient time on the job to receive unemployment insurance benefits. In the auto industry, moreover, many of those who have been laid off qualify for supplemental unemployment benefits.

Thus, the social and economic significance of present unemployment has been influenced materially by the changes in the structure of our labor force, and by the nature of the economic adjustment process we are now passing through. I do not wish to minimize the hardships that unemployment brings to many families and, in some cases, to whole communities. A strengthening of our unemployment insurance system along the lines proposed by the Administration would help to reduce these hardships, and so, too, would rapid expansion of training programs and computerized job banks. By these devices both the amount and the burden of unemployment can be kept down. And surely, if we succeed in limiting the extent of the current economic adjustment and lay the groundwork for a prolonged rise in economic activity with stable prices, the costs that are being paid to rid ourselves of the menace of inflation will be more than justified.

Monetary Policy

Let me turn now to the basic tasks of monetary and fiscal policy that lie immediately ahead.

The Administration's Budget calls for tight control over expenditures to keep excess demand for goods and services from reemerging. Apart from a temporary rise in the second quarter, when checks will be sent out to cover the retroactive portion of the increase in social security benefits, the path of total Federal expenditures scheduled for calendar 1970 rises very little. This is the kind of policy we ought to pursue now, and I would urge the Congress to take the necessary action to ensure realization of the degree of stringency called for in the budget.

I noted in my testimony before the Joint Economic Committee a month ago that the task of monetary policy in the year ahead will be to tread the narrow path that lies between too much restraint and too much ease. Monetary policy must do what it can to ensure that the retrenchment in industrial production, which has been in process since last July, does not go on much longer or threaten to become more widespread. We must be careful, however, to avoid stimulus to later spending on a scale that could jeopardize the progress we have made in our battle against inflation.

I also stated a month ago that the Board realizes that monetary policies as severe as those pursued in the latter half of 1969 could not continue indefinitely. In this regard, the questions the Federal Reserve has had to face--and is facing now--relate to the timing and the degree of relaxation of its control over the growth of bank reserves, bank credit, and the money supply. Unhappily, a central banker cannot discuss such issues freely without running the risk of rocking financial markets. I must avoid such an indiscretion. I would like, however, to review briefly for the Committee some of the salient developments in financial markets during recent weeks.

Of greatest significance to borrowers is the marked decline that has taken place in interest rates. Yields on 3-month Treasury bills, for example, have dropped from over 8 per cent in late December to well below 7 per cent recently. Yields on short-term securities of Federal agencies have shown a similar decline. Commercial paper rates have fallen from over 9 per cent to 8-1/2 per cent. Long-term security markets also have witnessed appreciable interest rate declines, though during the last week or so long-term yields have moved up again. Such temporary reversals are not uncommon, representing as they do the swings that occur in market psychology and short-term changes in the supply of new securities.

The downward interest rate adjustments that have taken place reflect primarily a recognition by market participants that the economy is slowing, that inflationary expectations are beginning to be replaced by more sober judgments about the outlook for prices, and that some easing in monetary policy might soon take place. Whatever their source, these adjustments have given rise to a considerable, and very healthy, lessening of tensions in credit markets.

In the early weeks of this year, the decline in interest rates occurred while most monetary aggregates were contracting. In recent weeks, however, these aggregates have shown a stronger tendency. With market interest rates declining and ceiling rates on time and savings deposits higher since late January, banks have been able to attract funds that otherwise would have gone into market securities. Since the week of February 4, total time deposits of commercial banks--which last year declined by 5 per cent--have been increasing at an average rate of about $400 million to $500 million per week. The money supply too has grown moderately in recent weeks. And weekly statistics suggest that total bank credit--that is, loans and investments--has also begun to rise again.

I would not wish to make too much of the magnitude of changes in these variables, since erratic movements often take place in the short-run. The important point is that the direction of these financial quantities has changed; their trend is no longer downward, as it was earlier.

As 1970 progresses, the Federal Reserve will stand ready to adapt monetary policy to actual and prospective economic developments. Although uncertainties as to the course of economic development are considerable, we do not propose to stand idly by and watch the current adjustment degenerate into a recession. Neither do we intend to let excess demand for goods and services burst out anew later this year--fueled either by excessively high rates of business capital spending or by other sources.

Perhaps I am overly optimistic, but I think we stand a reasonable chance of avoiding both extremes. I would hope to see economic conditions emerge in 1970 that will be conducive to early renewal of sustained economic growth and to further reductions in the level of interest rates. By any standard except that of the very recent past, the cost of credit in this country is exceptionally high. Interest rates are still at levels that would have seemed unthinkable just a few years ago. If the rate of advance of the general price level gradually abates in 1970, as I believe it will, borrowing at today's interest rates will appear extremely unattractive to businesses and other borrowers.

The tranquilization of inflationary pressures we so urgently need, and for which all of us in government have been working so hard, is within our grasp this year. We have succeeded, with our monetary and fiscal policies, in slowing the growth of total spending to the point where excess demand for goods and services has been eliminated. In due course, the benefits of this slowdown will be evident in a moderation of price advances.

Progress toward this end will be enhanced if businesses and labor leaders exercise moderation in their wage and price policies this year. The principal responsibility for economic stabilization, however, rests on the shoulders of the government. The task ahead is a formidable one. We must firmly establish this year the basis for lasting growth without inflation. But we must also avoid a recession. The role of both monetary and fiscal policies in achieving these objectives is of critical importance. We cannot afford to err either in the direction of too much restraint or too much stimulus. The stakes are much too high. I assure you that the Federal Reserve will do its very best to avoid both extremes.

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