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Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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It is a pleasure to meet with this Committee again to present the views of the Board of Governors on current economic and financial conditions. As we are all well aware, the performance of the economy thus far in 1970 has left much to be desired. I believe, however, that the available evidence indicates that our economy is basically sound and resilient, and that we are making progress in resolving the inflationary problems that have plagued us over the past five years.

A year ago at this time, we were still searching for ways to deal with the upsurge in demand that had given rise to a dangerous degree of inflationary pressure. The income tax surcharge was extended for another year; Federal expenditure programs were curbed, and monetary policy moved to a highly restrictive posture over the summer months. The consequence of these policies has been a significant slowing in the pace of total spending, an elimination of excess demand, and a period of relatively sluggish economic activity. The process of wringing out the inflationary excesses of the past has not been painless, but the alternative of letting inflation run rampant would have been utterly disastrous.

The economic adjustment under way since the latter part of 1969 reflects in large part a decline in the resources devoted to residential construction and the national defense. The latter decline is less widely recognized than the former. During the past year the Armed Forces have been cut back by about 350,000 men, and civilian employment in the Department of Defense has dropped another 75,000.

Moreover, production of defense equipment during the past year has fallen almost a fifth, and is now nearly 25 per cent below the peak reached in the late summer of 1968. Employment in defense-related manufacturing industries began to edge down a little more than a year ago, and the rate of decline accelerated in the first half of this year. In June, employment in these industries was 14 per cent below that of a year ago.

As a result of this reduction in defense jobs, communities heavily dependent on defense production have faced difficult adjustments. It is evident, however, that the long-run benefits of defense cutbacks greatly outweigh these transitional developments. We have needed to free resources for other high priority uses, and we should welcome the contribution that reduced defense spending has made--and will continue to make--to abatement of inflationary pressures.

In view of the declines in defense industries, homebuilding, and some other branches of production, a sizable effort on the part of the business community to bring inventories into better balance with sales and orders was to be expected. In fact, the annual rate of inventory accumulation has fallen by about \$9 billion since the third quarter of last year. This is the largest decline of any category in our national income accounts.

Total private final demand--that is, demand for goods and services other than for inventory accumulation--has held up rather well, despite the substantial cutback in outlays for residential construction.

Continued expansion in business expenditures for plant and equipment was an important sustaining force in the second half of last year, though such outlays have leveled off recently. Consumption expenditures, however, have remained quite strong. In each of the past three quarters, consumer purchases have risen at annual rates of a little more than 7 per cent. This is higher than the rate of increase in prices, so that consumer takings have continued to advance in real terms. Federal supplements to disposable income--starting with the January reduction in the surcharge--have contributed to the strength of consumer spending. The expiration on July 1 of the remaining portion of the surcharge should further bolster consumer buying in the months ahead.

With consumer outlays growing and business fixed investment expenditures reasonably well maintained, the overall economic adjustment since last summer has been much milder than in any of the recessions since World War II. For example, the 3-1/2 per cent decline in industrial production since last July contrasts with a fall of almost 6 per cent in the 1960-61 recession--the mildest of the postwar period. The decline in total manhours worked in nonfarm industries has also remained small by comparison with the 1960-61 experience.

In recent months, however, the effects of the economic slowdown have become increasingly apparent in the labor market. Total nonfarm employment, which continued to increase through March of this year, declined significantly during the second quarter, and the length of the workweek in manufacturing was curtailed further. The unemployment rate rose to 5 per cent in May; the decline to 4.7 per cent last month, though welcome, apparently resulted in part from special factors. While layoffs in manufacturing have been an important source of the increased unemployment, many of the new entrants to the labor force have also had difficulty in finding jobs. The number of women entering the work force was especially large in the first quarter, and substantial additions to the civilian labor force have recently resulted from cutbacks in the Armed Forces.

Clearly, we cannot afford to be complacent at this juncture. Further declines in employment and industrial production must soon be halted, if we are to avoid a significant deterioration of business and consumer attitudes. But as I interpret the incoming evidence from the real sector of the economy, there is little basis for anticipating a cumulative economic decline. Indeed, there are some signs that the decline may bottom out in the near future.

We learned last week, for example, that total real output of goods and services stabilized in the second quarter, after declining at a 3 per cent annual rate in the first quarter of the year. Total new orders for durable goods--an important advance indicator of economic developments--have remained approximately level during the past several months, following significant declines earlier. Claims for unemployment insurance since May suggest that the rate of layoffs has subsided, and that unemployment among workers covered by the insurance program may have stabilized.

It seems probable that the drag on the economy of a diminishing rate of inventory investment is now largely behind us. While the ratio of inventories to sales has risen and is relatively high at durable goods factories, this ratio has begun to decline at the retail level. The drop partly reflects developments in the auto industry, where dealer inventories have recently fallen while sales of domestic cars have strengthened considerably.

There are also indications that residential construction may already be turning up. The financial resources of savings institutions have of late improved significantly, and a larger volume of funds will soon be flowing through to the housing sector--where backlogs of demand are enormous. In recent months, the trend of both mortgage commitments and residential building permits has been upward. In June, the level of housing starts also increased. Thus, the recovery in home construction that we have been anticipating may actually be under way.

State and local spending, particularly on construction, is also likely to return soon to more normal rates of growth, partly because of the release of previously impounded funds, and partly also because of improvement in the money and capital markets.

In some sectors of the economy, however, expenditures will remain sluggish in the immediate future. Outlays for defense will fall further. It appears, also, that the boom in business expenditures for fixed investment has come to an end. Reports for recent quarters indicate that expenditures for new plant and equipment have been falling below businessmen's earlier anticipations, and that planned outlays have been revised downward. If historical experience is any guide, further reductions in these spending plans are likely.

This moderation in capital spending was to be expected, and it, too, should be welcomed. Continued large increases in capital outlays eventually would have raised excess capacity to a level threatening a serious investment decline later on. Furthermore, an ending of the capital goods boom of the past five years will tend to reduce upward pressures on prices, on costs, and on interest rates. This is added insurance that excess demand will not reemerge as economic activity turns up again, and that we will make further progress in getting inflation under control.

Thus far, our success in moderating inflationary pressures has been disappointingly small. Last month, for example, consumer prices continued to rise at about a 5 per cent annual rate. The

unwinding from the inflationary excesses of the past is proving a longer and more difficult process than we anticipated. However, while our economy is still some distance from the stability of costs and prices that we seek, progress is being made in this area--more progress, perhaps, than is generally realized.

We are now witnessing some clear signs of reduced upward pressure on prices. In the past four months, wholesale prices have risen at an annual rate of less than 2 per cent, compared with an increase of more than 6 per cent in the previous four months. Much of the improvement has been due to a decline in the prices of agricultural products as supplies of some basic commodities have become more ample. Also, however, the rate of price increase has moderated for a number of important industrial commodities. Prices of sensitive materials, such as copper, steel scrap, rubber, and tin have fallen both here and abroad. In addition, reports are multiplying that many business firms have begun to shade list prices--offering discounts that are not fully reflected in the price indexes.

This improved performance of wholesale prices reflects intensified competition in product markets and a marked change in the trend of productivity and unit labor costs in manufacturing. Last year, output per manhour showed almost no growth--partly because of labor hoarding, but also because business practices had become generally lax in an inflationary environment. This year,

as sales weakened and profit margins deteriorated, closer attention to costs and efficiency has come to pervade the business community. Many manufacturers have begun to release some of their excess work force, overtime has been cut back, and other cost-cutting measures have been widely adopted. The result has been a distinct improvement in the trend of productivity, and a sharply reduced rise of unit labor costs in manufacturing--even though unduly large increases in wage rates have continued.

These are signs that the elimination of excess demand last year brought about by restrictive monetary and fiscal policies is beginning to bear fruit. With the attitudes toward cost control that now prevail in the business community, we may expect this improved rate of productivity in manufacturing to be extended, to spread to other sectors of the economy, and indeed to accelerate as growth in output resumes. The prospect for gains in productivity is especially favorable now, since a large part of the outlays for capital goods during recent years has been for modernization and improvement of plant capacity. The benefits of improved technology should be increasingly realized in the months ahead.

I believe, therefore, that we can look forward to further abatement of upward pressures on unit labor costs and on industrial commodity prices in the latter half of this year. And as the effects of these developments work their way through to consumer prices, the prospects for lower and more reasonable wage settlements will be enhanced.



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The return to general price stability will, of course, be hastened if greater moderation is practiced with regard to wages and prices. I welcome, therefore, the measures taken by the Administration to enlist the aid of business and labor in voluntary efforts to improve productivity and to curtail excessive price and wage increases. There is reason to hope that a system to identify and call attention to inflationary wage and price developments will mobilize public opinion against behavior that is prolonging the inflation. But we must remember that success in our efforts to regain full employment without inflation will depend principally on the conduct of monetary and fiscal policies.

Let me turn now to the implications that domestic economic developments have for our international balance of payments. Trade experience this year has been encouraging, but the overall balance on international transactions is still far from satisfactory. As the year began, our trade balance was improving, with the pace of economic activity slowing down in our country but rising briskly abroad. In the first half of 1970, the trade surplus rose to an annual rate of \$2-1/2 billion or more--compared with less than \$1 billion in 1968 and 1969. We expect further improvement in the year ahead.

The increase in the trade balance has occurred despite a high rate of imports, considering the sluggishness of domestic economic activity. The high rate of imports undoubtedly reflects

the persistent inflation in the United States during the past five years, which has given foreign competitors an added advantage. Inroads into our markets by foreign competitors cause dislocations, as all competition does. But the nation also benefits from the added incentive to our business firms to innovate, cut costs, and increase productivity. Moreover, if we attempt to hold down imports through administrative limitations, we will suffer injury to our exports as foreign countries retard their liberalization policies or retaliate with restrictive measures of their own, as they well may.

While the trade balance has recently strengthened and some increase has also occurred in receipts of investment income, capital movements have been adverse and our overall balance of payments is still registering very large deficits. Looking ahead, we can reasonably expect some improvement in international capital flows. As the economy recovers, our markets are likely to become more attractive to foreign investors. Also, outflows of U.S. private funds, which appear to have been exceptionally large in the first half, should diminish. Together with the stronger balance on goods and services that we anticipate, we should therefore see some reduction in our overall deficit.

However, to obtain lasting improvement in the balance of payments, we must continue to pursue domestic policies that restrain advances in costs and prices. By doing so, we will serve our national interests and also contribute to the maintenance of a viable

international monetary system. At the same time, our policies must provide reasonable assurance of early recovery in output and employment. The health of the world economy, as well as our own, depends heavily on orderly economic growth in the United States.

The appropriate course for monetary policy in 1970, as I stated at the Hearings of this Committee last February, is to tread cautiously the narrow and slippery path that lies between too much restraint and too much ease. Early this year, when many of the advance economic indicators were pointing downward, there was a need to permit resumption of moderate growth in the supply of money and bank credit. At the same time, however, we knew from unhappy past experience that too abrupt or too large a change in the course of policy could jeopardize our chances of success in the battle against inflation.

Looking back from our present vantage point, it seems to me that we have achieved the middle course with regard to monetary aggregates that we sought. During the second quarter of this year, the money supply grew at an annual rate of about 4-1/2 per cent, compared with a rate of about 3-3/4 per cent in the first quarter and virtually no growth over the preceding six months. Commercial bank credit (including loans sold to affiliates) showed little increase in the first quarter, since many holders of time deposits were still withdrawing funds from the banking system in the early weeks of the year. In the second quarter, growth of bank credit advanced to an annual rate of about 5-1/2 per cent.

The increased growth rate of bank credit in the second quarter resulted, in part, from a return flow of time deposits into the commercial banking system. The turnaround in time deposits was aided by the January increase in the ceiling rates that depository institutions could offer. This action brought ceiling rates into closer alignment with prevailing market rates of interest. Also, market rates began to decline soon after the turn of the year--especially rates on short-term securities, which have remained well below their 1969 highs. Yields on time and savings deposits thus became more attractive, and deposit inflows improved at the nonbank thrift institutions as well as at the commercial banks. Growth of savings accounts at mutual savings banks and savings and loan associations, taken together, was at about a 7 per cent annual rate in the second quarter of this year--compared with growth in the 1-1/2 to 2 per cent range during the latter half of 1969.

The principal instrument of monetary control employed this year to ensure a renewal of moderate growth in the monetary aggregates has been open market policy. To this end, the Federal Open Market Committee has placed increased stress on the longer-run objective of achieving an appropriate growth rate of money and bank credit. There was for a time, I believe, widespread misunderstanding as to the significance of that change in operating procedures. A few clarifying comments may therefore be helpful in laying this matter to rest.

An impression seems to have prevailed in some quarters that the Federal Reserve had decided to pursue fixed target rates of growth in the monetary aggregates on a more or less continuous basis. This was a misreading of our intent. We believe that the nation would be ill-served by a mechanical application of monetary rules. We know that large, erratic, and unpredictable short-run changes often occur in demands for money and bank credit. One of the important functions of a central bank is to prevent such short-run shifts from interfering with the smooth functioning of money and capital markets. We have no intention of abandoning our responsibilities in this area.

The evidence from the first half of this year indicates that performance of this function need not compromise a longer-run objective of maintaining an orderly rate of monetary expansion. Thus, large month-to-month changes have occurred recently in the growth rate of the money stock--in response to unusual factors influencing the public's demand--but over the past six months the annual growth rate averaged out to a little over 4 per cent.

Let me assure you, moreover, that the Federal Reserve does not view its responsibility as merely that of assuring reasonably steady growth of the monetary aggregates over the longer run. Our obligation as a central bank is more basic. It is to promote monetary conditions conducive to full employment,

rapid improvement in productivity, reasonable price stability, and equilibrium in the balance of payments. We do not propose to let adherence to any fixed growth rate of the money supply stand in the way of achieving these objectives.

We are well aware, also, that the oldest and most traditional function of a central bank is to serve as a lender of last resort. As this Committee knows, our money and capital markets experienced unusual strains during the past few months. The tensions resulted from a variety of forces--heavy corporate demands for long-term credit, expectations of large Treasury borrowing in the latter half of this year, disappointment over the slow progress in getting inflation under control, concern that some prominent firms might be financially over-extended, and so on. In my judgment, the strains in financial markets stemmed in large part from irrational fears of lenders and borrowers, rather than from careful calculations of the fundamental factors underlying the demand for and supply of credit. Whatever their source, however, we know that anxieties of this kind could lead to a scramble for liquidity whose effects might endanger the prospects for recovery in output and employment.

To date, efforts by business and financial firms to strengthen their liquidity position have remained orderly and selective, and they should diminish as it becomes increasingly

apparent that we are making real progress in the battle against inflation. But I want to assure you that, in the highly unlikely event that a liquidity scramble developed, the Federal Reserve would use all the authority at its command to ensure that unusual demands for liquidity were satisfied.

Demands for liquidity, even exceptional demands, can ordinarily be met by using conventional monetary tools. Credit demands on the banking system at large can be accommodated by open market operations, while the needs of individual member banks can be met through the discount window. Both instruments have been used constructively for this purpose in recent weeks. We have found, also, that minor adaptations of conventional monetary tools can provide solutions to special financial problems. Thus, once it became apparent that some firms were having difficulty in refinancing their maturing obligations in the commercial paper market and might therefore need to increase their bank borrowings, the Board moved promptly and on June 23 suspended Regulation Q ceilings on large denomination certificates of deposit with maturities of less than 90 days. This action has enabled banks to obtain funds that investors might be hesitant to place in other markets, and to rechannel these funds to borrowers previously dependent on issuance of commercial paper. Also, it was made clear that the discount window would be available to assist banks in meeting the needs of businesses unable to roll over maturing commercial paper, and member bank borrowings for this purpose subsequently have risen. Increases in bank credit resulting

solely from a rechanneling of funds represent a redistribution, and not an addition to the supply, of loanable funds.

These conventional tools are buttressed with stand-by procedures to permit the Federal Reserve to make funds available to creditworthy borrowers facing unusual liquidity needs through "conduit loans"--that is, loans to a member bank to provide funds needed for lending to a qualified borrower. Administrative arrangements for making such loans to nonmember banks and to nonbank thrift institutions were developed in 1966 and updated in 1969. Furthermore, the Federal Reserve could--under unusual and exigent circumstances--utilize the limited power granted by the Federal Reserve Act to make direct loans to business firms on the security of government obligations or other eligible paper, provided the borrower is creditworthy but unable to secure credit from other sources.

The powers of the central bank as the ultimate source of liquidity can, and obviously should, be reserved for extraordinary circumstances. Our financial institutions have demonstrated that they are sufficiently strong and flexible to handle with their own resources the needs of creditworthy borrowers--even when these needs are exceptionally large. In recent weeks, the nation's commercial banks have shown that they are able on short notice to put together very large lines of credit to meet the needs of creditworthy borrowers experiencing temporary financial difficulties. The banks that played so vital a role in these credit arrangements have served the nation well.

The fact that we have weathered so successfully the financial stresses of recent weeks has renewed confidence in the resiliency of our financial system. The consequence has been a noticeably more tranquil atmosphere in financial markets. But prudence requires, I believe, that we consider what additional precautionary measures might be advisable.

There are now bills before the Congress to provide insurance for customers' accounts in brokerage houses and for shares held in Federal credit unions. These deserve prompt attention.

The Congress might also give consideration to the feasibility of establishing a Federal program to guarantee loans to necessitous borrowers. This possibility should, of course, be explored very cautiously. It would be a disastrous mistake to use Federal monies to keep unsound firms from failing, or to substitute public for private tests of creditworthiness, or to convey the impression that the Federal Government will bail out loosely managed or speculative enterprises. But there may be a role for Federal guarantees in helping basically sound firms that experience temporary financial distress to find access to funds, where the alternative might be a degree of financial dislocation inimical to the national interest.

Let me conclude, now, by reiterating what I indicated at the outset. Our economy and our financial system have experienced unusual strains and stresses this year. The tests we have weathered indicate that our economic and financial structure is built on a solid

foundation. Confidence has been preserved, long-term interest rates have declined in recent weeks, equity prices have made some recovery, and a much calmer atmosphere has come to prevail in financial markets. Meanwhile, we have avoided excessive monetary stimulation and paved the way for resumption of sustainable economic growth.

In the real sectors of the economy, the weaknesses that developed earlier this year have been contained, and I believe we can look forward to an early and orderly recovery in output and employment. The recovery, I both hope and expect, will be characterized by a well-balanced structure of output. Residential construction and State and local outlays should pick up, consumer expenditures should strengthen further, while business outlays on fixed investment taper off. And, with productivity trends already improving, we have good reason to expect further diminution of upward pressures on costs and prices.

This assessment of the strength and resilience of our economy will be tested in the months immediately ahead. Meanwhile, we at the Federal Reserve Board recognize that the future of man's lot on earth can be only dimly foreseen. That is why we always stand ready to revise our judgments and policies in the light of unfolding experience.

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