H.S.
Business Council
Oct. 17, 1970

I. I shall speak principally on monetary developments (but comment briefly also on general state of economy -- the economic and financial outlook.

II. The objectives of monetary policy during the current year were as follows:

1) First - to cushion the decline in economic activity;

2) Second, to lay the financial basis for resumption of economic growth without releasing a new wave of inflation.

3) Third, to meet the special financial problems that were heritage of past inflationary excesses and speculative practices.

III. Let me turn to first two objectives. The record indicates that the Federal Reserve Board has thus far succeeded in finding a middle course between monetary restraint and excessive monetary stimulus.

Thus, according to published figures, the money supply 3.8, 4.2, 4.5.

Underlying this smooth quarterly development [very large week-to week and month-to-month changes took place; but what the record as a whole indicates is that longer-run objectives need not be compromised in accommodating short-run shifts in credit markets].

Some concern has recently been expressed in business and financial circles about the rapid increase of late in bank credit.

This increase has indeed been very rapid -- 17% in third quarter.

However, not a sign of great credit ease --

for it represents in large part a recycling of credit

from the commercial paper market ~~and~~ to the banks;

i.e., a substitute of bank credit for commercial paper credit.

Special problem -- Since last spring the Federal Reserve Board has had to deal with exceptional strains in financial markets.

a) In the past three or four years the commercial paper market has grown by leaps and bounds. This represented a vast, new, and entirely unregulated banking system.

When on Sunday, June 21, the Penn Central petitioned for relief under the Bankruptcy Act, a heavy cloud was cast not only on the commercial paper market, but on the outstanding debt of all except the highest grade business firms.

To prevent an imminent financial crisis, by noon of Monday, June 22, every bank of any size in the country was informed that ~~a~~ the discount window would be kept open -- so that the credit needs of business firms whose commercial paper was maturing could be accommodated by the banks.

The same day the Federal Reserve Board also decided to suspend the interest rate ceiling on large certificates of deposit with a maturi~~ng~~ty of less than 90 days, so that commercial banks could acquire the funds they needed to lend to commercial paper borrowers who were unable to rollover their maturing obligations.

In the nervous days that immediately followed, the country's large banks played their part ~~-- a magnificent role --~~ by mobilizing on a magnificent scale lines of credit for sound borrowers who were caught in a liquidity squeeze, and thus prevented a dangerous wave of bankruptcies across the country.

b) While the Penn Central case was the most serious episode with which the Federal Reserve had to deal this year, there were, in fact, recurring fears last spring and summer of a liquidity crisis.

The Federal Reserved acted to dispel these fears by pumping massive reserves into the banks from time to time, but doing so on only a temporary basis.

Furthermore, the Board reduced margin requirements in May when equity markets were in disarray.

And in August carried out both a structural reform and an easing of monetary policy by simultaneously reducing reserve requirements on time deposits and imposing a new reserve requirement on commercial paper issued by bank affiliates.

IV. The general and specific monetary actions that I've stated have had and are having a constructive effect.

Order has been restored in financial markets.

A financial basis for recovery has been laid.

Short-term interest rates are now sharply lower than they were at their peak last December.

In view of the extraordinary number of new bond issues, long-term interest rates have remained sticky, but they too are appreciably lower than they were at their peak in May or June.

Furthermore, monetary aggregates are again growing at a rate sufficient to foster expansion but without releasing new forces of inflation.

Credit has become more readily available and is already financing a significant recovery in homebuilding and state and local construction.

Finally, stock prices have improved and the threat of failures of stock exchange firms has substantially deteriorated.

V. The improvement on the stock exchanges reflects, of course, not only the restoration of confidence in our financial system; it reflects also the corrective adjustments now under way in the nation's business enterprises.

The rate of corporate profits, taken in the aggregate, began eroding in the fall of 1965.

Since then, the average rate of profit has fallen steadily, and is now lower than at any time since the end of World War II.

During the hectic inflation from 1965 to 1969, the erosion of profits was largely ignored by the business community.

One of the great perils of inflation is that underlying economic developments are masked by rising prices.

It is only in the past six to twelve months, as the result of the slowdown in the economy, that businessmen have become acutely aware of the squeeze on profits and of the urgent need to economize.

A vigorous cost-cutting process is now under way in the business world -- indeed, cost cutting is more widespread and more intense than any time since World War II.

The result is that productivity is again improving. The three years 1967-69 produced a negligible gain in productivity; but new output per man hour is again rising briskly.

During 1969, no increase.

First quarter, when production was being cut back, -2.9

Second quarter, when production stabilized, 3.3

Third quarter, 5.3

This imporvement in productivity, at a time when wages are rising very rapidly, is the main reason for confidence that progress is being made in the battle against inflation.

When wages are rising 7% and productivity 5%, labor cost per unit is rising merely 2%.

This is a vast improvement over last year's conditions.

But while I have great confidence that our economy will make substantial progress in the battle against inflation over the year ahead, I must confess to you that I have apprehensions when I look beyond a year.

These apprehensions stem mainly from the rapid upward thrust of wages.

The increases of wages called for in new collective bargaining settlements are not moderating; on the contrary, despite the increase in unemployment, they are accelerating.

In the third quarter of this year, the first year increase in new settlements in the construction industry came, on average, to ~~18~~ 19%, and in manufacturing to 9%.

If wage increases on this scale continue, increases of productivity of 3 or 5 ~~oxx~~ % would not suffice to prevent the emergence of a new wave of inflation.

I am therefore deeply concerned about the violent cost-push that is now in process.

I am concerned also about the balance of payments. While our trade balance has recently improved, capital payments have been adverse and, if interest rates go down further, capital movements may become much more adverse. In any event, our country faces this year an extrarodinarily large deficit in balance of payments.