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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I am pleased to meet with you again today to report the views of the Board of Governors of the Federal Reserve System regarding the state of the economy at mid-year.

Since I last appeared before this Committee on February 19, it has become evident that a cyclical recovery of our economy has commenced. Indicators of future business activity, which were already rising in the latter part of 1970, have strengthened further. Comprehensive measures of current activity--such as the physical volume of industrial production, total employment, retail sales adjusted for price changes, and total real output of goods and services--have shown moderate improvement as the year has progressed. We are confident that this recovery process will continue and broaden in the months to come.

Nonetheless, some of the economic problems that have troubled us as a people over the recent past are still much in evidence. Large increases in wages and prices persist in the face of extensive unemployment of labor and capital. The international balance of payments remains unsatisfactory; indeed, our fragile export surplus has disappeared in recent months. In financial markets, interest rates are responding to fears of continued high rates of inflation by moving up again despite rapid

monetary expansion. And while business profits have improved somewhat, they remain exceptionally low.

The cost-push inflation we are experiencing, and the widespread concern over continued rapid inflation, are a grave obstacle to the full economic improvement we all ardently seek. As long as inflation persists, consumers are likely to remain rather conservative in their spending plans, fearing the possibility of budgetary over-commitment. As long as inflation persists, businessmen are likely to remain cautious in their investment policies, apprehensive that profit margins may erode despite higher prices. As long as inflation persists, financial investors will remain reluctant to commit funds to long-term securities unless they are compensated by a higher interest rate. Expectations of inflation thus permeate the gamut of private decisions to spend and invest, and this is restraining the private efforts needed for vigorous and sustained economic recovery.

A year or two ago it was generally expected that extensive slack in resource use, such as we have been experiencing, would lead to significant moderation in the inflationary spiral. This has not happened, either here or abroad. The rules of economics are not working in quite the way they used to. Despite extensive

unemployment in our country, wage rate increases have not moderated. Despite much idle industrial capacity, commodity prices continue to rise rapidly. And the experience of other industrial countries, particularly Canada and Great Britain, shouts warnings that even a long stretch of high and rising unemployment may not suffice to check the inflationary process.

I shall return to the causes and implications of this new rigidity in our economic structure at a later point. Let me turn first, however, to a brief review of economic developments during the first half of 1971, and to the supportive role that public policy has played--and will continue to play--in the evolving economic recovery.

Recent Economic Developments

The performance of the economy during the first half of 1971 is not easy to interpret because many cross-currents are always present in the vicinity of a cyclical turning point. In addition, the rebound from the extended auto strike last fall, and the accumulation of steel inventories in anticipation of a possible strike this summer, have been distorting the underlying trend.

Abstracting from these transitory influences, the record of the first half of 1971 is one of gradual, but quickening, recovery. Late last year, only the construction industry exhibited significant strength, as the sharp recovery in residential building that began in the spring was joined by renewed expansion in the construction programs of State and local governments. Early this year consumer spending began to improve, with increases of sales spreading to a wide variety of consumer items. The sales of retailers other than automobile dealers rose at about a 10 per cent annual rate in the second quarter--considerably more than normal and well above the rise in consumer goods prices. Recently, activity in our factories has also been stepped up, especially in consumer goods lines. The index of industrial production, adjusted to exclude autos and steel, rose at a 6 per cent annual rate between March and June.

The improving trend of business is being supported by a faster rate of growth in personal incomes. During the three months from March through May, total personal income rose at an annual rate of 8 per cent, compared with a 6 per cent rate over the previous six months. Governmental transfer payments, which have been contributing to recent income

growth, were particularly large during June when the retro-active increase in social security benefits was paid. The flow of private wage and salary payments has also quickened, in response to some gain in manhours worked as well as to continued large increases in wage rates. And while employers have not yet reentered the labor market for appreciable numbers of new employees, further business improvement should soon lead to faster employment growth also.

Inventory investment promises to supply an added source of economic impetus in the months ahead, after allowance for a probable rundown in steel stockpiles. Thus far in the recovery, there has been little accumulation of inventories, apart from the restocking by automobile dealers and strike-hedge buying by steel merchants and users. But with business sales rising, and the ratio of inventories to output and to sales declining in many lines, we are coming closer to the time when needs for larger inventories--of raw materials, work in process, and finished goods--will begin to express themselves. The adjustment of stocks to higher levels of activity will in turn generate further increases in output, employment, and incomes. This is a common element in cyclical recoveries, and I judge that

we are approaching that point in the current recovery process.

There are grounds for concern, nonetheless, with regard to some features of the recovery now underway. First, there is little evidence as yet of any material strengthening in consumer or business confidence. Recent surveys of consumer attitudes show only modest improvement, while uneasiness appears to persist among many businessmen and investors regarding the effects of continuing rapid increases in labor costs on future profitability. Confidence is likely to strengthen with the passage of time, as sales and employment conditions improve. But there is a danger that hesitation and uncertainty will continue on an extensive scale until significant progress is made in moderating inflation. Greater success in the battle against inflation is probably the most important single prerequisite of more rapid and enduring economic expansion.

Second, our international competitive position appears to have deteriorated. In the first five months of 1971, imports spurted and our normal trade surplus vanished. This is a distressingly poor performance in an economy experiencing substantial underutilization of its resources of labor and capital. The problem is dramatized by the success of foreign manufacturers in capturing a rapidly expanding share of our automobile

market. In the past six months, sales of foreign models have accounted for 16 per cent of total U.S. sales and, in addition, close to one-tenth of the American models sold were produced in Canada. It may be tempting to react to foreign competition by imposing added restrictions and quotas on imports, but such a policy would not serve our national interests. The constructive course is to bring inflation under control and to stimulate our businessmen to increase their penetration of the expanding markets abroad and to compete more effectively with foreign producers in our domestic markets. I would favor consideration of new government incentives toward this end.

Third, there is as yet no evidence of resurgence in business capital spending programs. New orders for capital equipment show little--if any--recovery from the 1970 lows when allowance is made for rising prices. Construction contract footage for commercial and industrial buildings remains far below earlier highs. Official surveys of business spending plans for plant and equipment show no increase, even in dollar terms, for the remainder of this year. The hesitation in business investment may reflect the sizable amounts of unused capacity that presently exist. But it also results, I believe, from low business profits and uncertainty about the profit outlook.

History indicates rather clearly that a vigorous, sustained economic recovery requires a strengthening trend in business capital investment.

We need to encourage business firms to undertake new capital investment; and I strongly supported, therefore, the liberalization of depreciation allowances recently adopted by the Treasury. I have also endorsed the general proposition that an investment tax credit be adopted permanently. At the moment, however, I am doubtful about the wisdom of restoring the investment tax credit--or of taking other stimulative fiscal actions--in view of the state of the Federal budget. In the fiscal year just ended, the budget deficit was in excess of \$20 billion. It will remain very large in fiscal 1972. Many influential citizens in the business and financial community view this situation with alarm, so that these large budget deficits have become an important psychological factor contributing both to inflationary expectations and to high interest rates.

A large part of the budget deficit is, of course, attributable to the shortfall in tax receipts stemming from sluggishness in the economy. Some expenditures, notably on unemployment insurance and welfare, have risen for this same reason. Even taking these factors into account, however, the Federal budget

is more stimulative now than a year or two ago. The President submitted in January a moderately expansive budget for fiscal 1972, and since then the net effect of Congressional actions has been to make it more stimulative. Social security benefits have been liberalized, retroactive to the first of the year, and the scheduled increase in social security taxes postponed for a year. The public service employment bill has become law, and it appears probable that the military pay raise bill will be larger than the budget proposals. These and other actions, along with increases in the so-called uncontrollable items in the budget, as Chairman McCracken reported to you, have served to raise estimated expenditures \$5 billion above those originally proposed for fiscal 1972, and to reduce estimated receipts by some \$2 billion.

I would not want to rule out additional fiscal stimulus if the recovery in the economy should prove to be well below normal proportions, particularly if such a move were preceded or accompanied by a more effective incomes policy. But I would urge caution at the present time. Once confidence becomes stronger, we may find that there is enough fiscal stimulus already at work. And in any case, the fear of inflation is much too great, and its potential effect on private behavior too negative, to run the risk of taking new fiscal actions that would now seem imprudent.

Monetary and Financial Developments

Let me turn next to monetary policy, and to the substantial contribution it has made to stimulating economic activity over the past year.

The shift toward monetary expansion early in 1970 was rather promptly followed by a resurgence in bank deposits and in the flow of funds to other financial intermediaries. As financial institutions rebuilt their liquidity, they became more eager lenders, the availability of credit increased greatly, and interest rates declined. As a result, housing starts rebounded and State and local government construction began to rise more briskly. More receptive credit markets also enabled our business corporations to issue new securities in record volume, thereby rebuilding their liquidity and putting themselves in a financial position to expand production and the capital investment that they may wish to carry forward later on.

Late last year, as this Committee knows, there was a marked decline in the rate of expansion of the narrowly defined money supply--that is, currency plus demand deposits. In these circumstances, a brief period of more rapid expansion in the money supply to compensate for the fourth quarter shortfall

seemed appropriate. The System, consequently, provided bank reserves liberally over the winter months, and interest rates--partly reflecting the increased supply of reserves--declined sharply further. Expansion of the narrowly defined money supply rose to a 9 per cent annual rate during the first quarter of this year; but the average growth rate for the fourth and first quarters combined, being little more than 6 per cent, remained very close to the earlier trend in 1970.

This March and April, the Federal Reserve System faced a dilemma. Information available at that time suggested that high rates of monetary growth might well persist under existing conditions in the money market. Interest rates, however, were already displaying a tendency to rise, and vigorous action to restrain monetary growth might have raised them sharply further. In view of the delicate state of the economic recovery, which was just getting underway, it seemed desirable to prevent the possible adverse effects of sharply higher interest rates on expenditure plans and public psychology. The Federal Open Market Committee decided, therefore, to move very cautiously toward restraining the growth of the monetary aggregates.

With the benefit of hindsight, I now feel that stronger action was warranted this spring. For, as matters turned out,

we experienced even faster monetary growth in the second quarter than had been anticipated, while interest rates also moved substantially higher. Present estimates indicate that the narrowly defined money supply rose at an annual rate of 11 per cent in the second quarter. However, growth in a more broadly defined money supply--that is, currency, plus demand deposits, plus commercial bank time deposits other than large denomination CD's--receded from an annual rate of 18 per cent in the first quarter to a rate of 13 per cent in the next three months. It is worth noting also that bank credit expansion has been considerably more restrained than growth in any of the measures of the money supply. Total bank credit rose at a 12 per cent annual rate during the first quarter and then dropped to a 7 per cent rate in the second.

It may be that the recent high growth rates in money balances, besides being a lagged response to the lower interest rates of this past winter, reflect some of the uncertainties of the general public about the economic situation. To the extent that this is true, the inclination to hold unusually large money balances should subside as economic recovery becomes more evident. In any event, it is clear that recent monetary growth

rates are higher than is necessary or desirable over any length of time to sustain healthy economic expansion. The Federal Reserve has, therefore, already taken some steps to reduce the growth rate of bank reserves and thereby promote a more moderate rate of monetary expansion.

These actions are partly responsible for the recent rise in interest rates--particularly interest rates on very short-term market securities. But it should be kept carefully in mind that the rise in interest rates since March has occurred despite rapid rates of monetary growth and continuing large flows of savings funds to depositary institutions. Factors other than monetary policy must therefore be primarily responsible for the upturn in interest rates this spring; they include in addition to indications that a business recovery is developing, the prospect of very large Treasury financing needs, deepening concern about the unrelenting character of cost-push inflation, some apprehension over international financial developments, and not a little anticipatory borrowing in the capital market on top of that currently needed. The fear of inflation appears to have been especially important in the recent behavior of our money and capital markets, and a reversal of psychology may well be required to achieve a significant downward adjustment of interest rates.

The rise in short-term interest rates during recent months had the effect of putting the Federal Reserve discount rate, which had been reduced in a series of actions to 4-3/4 per cent last February, well below the rates at which funds could be obtained by banks in the open market. The effect of this discrepancy in rates was to encourage member bank borrowing from the Reserve Banks--borrowing which was rising rapidly and thereby providing reserves to support continued high rates of monetary expansion.

Accordingly, as you know, the Board last week approved increases in Federal Reserve Bank discount rates to 5 per cent by a unanimous vote of the five Board members present at the meeting. I participated by telephone in the discussion leading to this action, and I want you to know that I supported it fully. Our hope is that the higher discount rate will serve to moderate the demand for discounting at the Federal Reserve, that it will help prevent excessive growth of the monetary aggregates, and also impart a degree of stability to interest rate expectations.

I continue to feel that the country needs lower interest rates, and that lower rates--especially on mortgages and State and local government securities--would contribute to a more vigorous economic recovery. But I am not hopeful that substantially lower interest rates can be achieved, until we as a

nation make steady and meaningful progress in solving our inflation problem.

Wages and Prices

The inflation we are confronted with has become deeply rooted since its beginnings in 1965. The forces of excess demand that originally led to price inflation disappeared well over a year ago. Nevertheless, strong and stubborn inflationary forces, emanating from rising costs, linger on. I wish I could report that we are making substantial progress in dampening the inflationary spiral. I cannot do so. Neither the behavior of prices nor the pattern of wage increases as yet provides evidence of any significant moderation in the advance of costs and prices. If growth in productivity accelerates with a quickening economy, some real moderation may well develop in the months ahead. Even so, the residual rate of inflation may well run above the characteristic level of previous cyclical upswings.

Let me cite some of the evidence that leads me to this view. Thus far in 1971, prices of newly produced goods and services in the private economy are still rising, on the average, at about a 5 per cent annual rate--or at essentially the same rate as in 1969 and 1970. The rate of advance of consumer prices

did diminish conspicuously during the first five months of 1971, but most of this improvement is attributable to the decline in mortgage interest rates. The wholesale price index for all commodities has increased at an annual rate of 5 per cent thus far this year, or twice last year's rate. Wholesale prices of industrial commodities, moreover, have accelerated from a 3-1/2 per cent increase last year to a 4 per cent rate thus far in 1971.

Much the same picture emerges from a review of changes in wages and salaries--by far the most important component of business costs. Wages in the private nonfarm economy, adjusted for changes in industrial composition and for overtime work, rose at about a 7 per cent annual rate in the first half of 1971--slightly more than in 1970 or 1969. This sustained sharp rise in wages during a period of substantial economic slack contrasts markedly with our experience in earlier recessions, when the rate of advance in wages typically dropped sharply or actually ceased.

Nor is the picture more encouraging when one inspects the trend of new agreements reached in major collective bargaining settlements--agreements which tend to establish wage

trends throughout industry. The wage increases agreed to, for example, in the automobile, can and aluminum settlements, and most recently by AT&T, amount to 12 per cent or more for the first year. The full extent of the increase contracted for later years is not yet known, since it will depend in part on the speed of future advances in the consumer price index.

It is important to inquire into the reasons for this unusual behavior of wages and salaries. The answer is doubtless complex, involving a myriad of structural, psychological, and social changes. Ironically, our national commitment to high employment and economic prosperity, and our relative success in achieving these objectives, accounts for part of the problem. For a general expectation has developed on the part of both business and labor that recessions, if they occur at all, will prove brief and mild; and this expectation has influenced both the strength of wage demands and the willingness of management to accept them.

A second factor contributing materially to the sustained character of wage rate increases in the current situation is the intensity and duration of the previous phase of excess demand. Consumer prices have been rising steadily since 1965--much

of the time at an accelerating rate. Continued substantial increases are now widely anticipated over the months and years ahead. In such an environment, workers naturally seek wage increases sufficiently large to compensate for the effects of past inflation on their real incomes, and to give some protection against future price advances--besides providing for a measure of improvement in living standards. Thoughtful employers are bound to have some sympathy with these efforts, all the more so when they reckon--as they now generally do--that cost increases can probably be passed on to buyers grown accustomed to inflation.

Other factors too have been at work. The increased militancy of workers, whether union or non-union and whether in private or public service, has probably led to wider and faster diffusion of excessive wage rate increases through the economy. I cannot help but wonder, also, whether our recent experience with wage settlements in unionized industries may not reflect a gradual shift in the balance of power at the bargaining table.

Labor seems to have become more insistent, more vigorous, and more confident in pursuing its demands, while

resistance of businessmen to these demands appears to have weakened--perhaps because they fear the loss of market position that would be caused by a long strike or because they believe that their competitors too will give in to similar wage demands. More recently, the balance of power--so important to the outcome of wage bargaining--may have been influenced by expansion in the public welfare programs which can be called upon to help sustain a striking employee and his family, valid though these programs may be on social grounds. And the hand of labor may have been strengthened also by the evident success that public sector employees have had in recent years in winning large wage increases, frequently with the use of illegal strikes against the government.

In my judgment, and in the judgment of the Board as a whole, the present inflation in the midst of substantial unemployment poses a problem that traditional monetary and fiscal remedies cannot solve as quickly as the national interest demands. That is what has led me, on various occasions, to urge additional governmental actions involving wages and prices--actions that would serve, by moderating the inflationary trend, to free the American economy from the hesitations that are now restraining its great energy.

There has been some progress in this area over the past year or two. The President deserves credit for his efforts to deal with the special supply-demand problems that had developed in the lumber and petroleum industries, and for bringing together labor and business leaders in the steel industry for a discussion of basic economic issues at the outset of the current wage negotiations. The Construction Industry Stabilization Committee, formed earlier this spring, appears to be having some success in moderating the staggering trend of wage settlements in that industry. The periodic Inflation Alerts serve a useful function in stimulating public discussion of areas in which wage or price decisions do not seem to conform to economic fundamentals. And the National Commission on Productivity may yet provide the basis for important improvements in the cost trends of our economy.

In the Board's judgment, these efforts need to be carried further--perhaps much further. The problem of cost-push inflation, in which escalating wages lead to escalating prices in a never-ending circle, is the most difficult economic issue of our time. It needs to be given top priority by our business

and labor leaders as well as by the government. There is much good will and statesmanship in the ranks of business and labor, and it would be wise for the government to draw upon it more fully.

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