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Statement by

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before the

Committee on Banking, Housing and Urban Affairs

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I appreciate the opportunity to participate in your discussion of S. 2712. This bill, besides extending the Economic Stabilization Act, brings interest rates and dividends under its umbrella of potential controls. I therefore appear before you in my capacity as Chairman of the new Committee on Interest and Dividends.

Let me say, at the outset, that the most urgent economic task facing our nation is to make a success of the stabilization program initiated by the President on August 15.

The current price and wage freeze is a major step in breaking the hold of inflation on our country. The freeze must be followed by effective restraints on the upward movement of wages and prices, so that a solid foundation may be laid for the early restoration of general price stability under free market conditions.

This high objective will require unreserved, continuing support of business, labor, and the population as a whole. It will require the support of sound fiscal and monetary measures. And it will entail the extension and amendment of the Economic Stabilization Act to assure continuity of the new policy.

As Phase II of the wage and price policy gets under way, one of our major assets is the wide public acceptance of Phase I.

If this early success is sustained, which I consider likely, confidence will grow that full prosperity can be attained without inflation. Under those conditions, we can expect business and consumer spending to continue to increase; we can expect wage demands to moderate; and we can expect further reduction of the inflation premium built into interest rates.

Before turning to the mission of the Committee on Interest and Dividends and its relationship to Phase II, I should like to make a few broad observations on the economic setting which launched our nation on its stabilization policy of mid-August.

Need for the Freeze

Over the past two years, strong cost and price pressures had persisted in the face of rather sluggish demand for goods and services, a high rate of excess plant capacity, and more extensive unemployment than the American people will long accept. In part, the cost pressures stemmed from efforts by workers and their trade unions to compensate for the eroding impact of past price increases on their real earnings. But they also reflected the efforts of labor to anticipate future price increases. Both labor and management came to expect that inflation would persist, and that it might become our way

of life. In this environment, labor typically demanded large wage increases, and business firms typically met these demands in the belief that higher costs could be passed on in the form of higher prices.

As the pace of inflation quickened, expectations of continuing inflation began to dominate economic decision-making. Between mid-1970 and mid-1971, average hourly compensation of workers in the private economy rose from 7 to 8 per cent. Major collective bargaining contracts negotiated over the same period called for first-year increases averaging 11 per cent, while increases over the life of the contracts--without considering future advances under cost-of-living escalators--were to average over 8 per cent per year.

Wage increases of this magnitude outstripped productivity gains by a wide margin, and made price advances inevitable. Even so, profit margins shrank, and during 1970 reached the lowest level experienced in the post-World War II period. The declining trend in profits, of course, intensified pressure on business firms to raise their prices.

The wage-price spiral that had developed threatened our economic recovery, which rested much too heavily on residential

building. Businessmen showed little enthusiasm for new capital investment. Consumers were likewise cautious in their buying and permitted their savings to mount. Moreover, foreign producers had become more successful, both here and abroad, in competing against domestically-produced goods. In consequence, our balance of trade swung into a virtually unprecedented deficit, and this too affected adversely our domestic production and employment.

Inflationary expectations were also tending to retard declines in long-term interest rates. The easing of monetary policy that began in early 1970 led to a very sharp decline in short-term interest rates. For example, the 3-month Treasury bill rate dropped from 8 per cent to about 3-1/4 per cent by March 1971, its most recent low. Over roughly the same period, yields on high-grade new corporate bond issues declined from 8-1/2 per cent to only around 7 per cent. The unusually wide spread that developed between long and short interest rates reflected in large part the inflation premium that buyers of long-term securities demanded and borrowers were willing to pay.

Monetary and fiscal policies, meanwhile, had gone about as far as was prudent in the circumstances. The money supply was

growing rapidly. Banks and other financial institutions were amply supplied with funds. The deficit in the Federal budget was already large and still increasing. The liquidity of business firms was largely restored. In this situation, additional stimulative efforts would have run the serious risk of augmenting inflationary fears, thereby threatening more hesitation by business and consumers, still higher long-term interest rates, higher prices, and further deterioration of the balance of payments.

In this state of our national economy, more and more thoughtful citizens became convinced that an incomes policy was temporarily needed to speed the transition from rapid inflation to general price stability. Properly executed, such a policy could change the psychological climate, help to rein in the wage-price spiral, squeeze some of the inflation premium out of interest rates, and improve the state of confidence sufficiently to lead consumers and business firms to spend more freely out of the income, savings, and credit available to them. Thus the nation was in a mood to respond favorably when President Nixon announced his new wage-price policy, as a part of a comprehensive plan for orderly economic growth, embracing

also taxes, expenditures, and our international trade and payments balances.

Period of the Freeze

It is, of course, too early to speak with certainty about the degree to which the new economic program has changed the economic climate. But the available information suggests that during the period of the freeze it has been working in the right direction.

The freeze appears to have effectively halted the spiral of prices and wages. Average hourly earnings in the private sector of the economy levelled off in September. Wholesale prices actually declined. And the consumer price index, which moderated to an annual rate of rise of 2-1/2 per cent, would probably have shown even greater improvement with more precise measurement techniques.

The new mood of confidence in our nation's ability to control inflation has also led to reductions in interest rates. Since mid-August long-term market interest rates have come down 3/4 to 1 percentage point, while short-term market rates have declined about 1/2 to 3/4 of a percentage point.

In the meantime, signs of improvement in economic activity have been gradually gaining. Figures for September show a good expansion in retail sales, with automobile sales particularly strong. Industrial production rose. And employment increased sharply, with gains widespread among various industries. Contracts for commercial and industrial construction spurted. However, orders for business capital equipment have thus far remained sluggish.

Post-Freeze Period

Once the economic recovery gathers momentum, we can expect the nation's unemployment problem to be substantially alleviated. To assure this outcome, we must maintain and extend the psychological and real benefits gained during the past two or three months.

The period of the freeze will soon be followed by a more flexible program of wage and price restraints. The objective of policy is to bring the rate of increase in the general price level down to 2-3 per cent by the end of 1972. This would represent a cutting in half of the recent inflation rate, and would be a major accomplishment.

This objective must not be compromised. If we succeed, our economy will be once again on a path leading to non-inflationary growth, and we may therefore look forward to a bright economic future. If, however, we fail, our economy will suffer grievously-- not only next year but also in later years.

The actual outcome will depend crucially on the practical wisdom of the new Pay Board and Price Commission. They will be subject to many pressures for wage and price adjustments on equity grounds, for reasons of catch-up or comparability. These may be particularly intense in the period immediately following the outright freeze. Still, over the longer run, as the wage-price program of Phase II takes hold, it is essential to our nation's future that overall wage and price adjustments be contained within the reasonable limits set by the President and his Cost of Living Council.

The Future of Interest Rates

Let me turn now more directly to the subject of interest rates and the role of the Committee on Interest and Dividends. Since inflation has exercised a significant influence on interest rates in recent years, it seems clear that the future of interest rates will depend heavily on the success of the wage and price

program. If telling progress is made in curbing advances in the price level, as can be reasonably expected, the inflation premium built into the interest rate structure over the past few years will be appreciably reduced. However, this premium will not be eliminated immediately; the inflationary attitudes that developed over the past half-dozen years will retreat only gradually as success in the struggle against inflation is demonstrated.

As I noted earlier, we have already experienced some reduction of interest rates in consequence of the initial reaction of borrowers and lenders to the new economic program. Further declines in the months ahead are probable if wage and price pressures are visibly curbed. Once businessmen come to believe that interest rates are not destined to move ever higher in the future, long-term credit demands from corporations-- which have been very large in the past year and a half--are likely to abate. When key market interest rates--such as corporate bond yields--continue to decline, the downward pressure exerted on the rate structure can be expected to work through to other, less volatile areas, such as the rates charged by lenders on mortgage and consumer loans.

We have to recognize, however, that as the pace of economic recovery accelerates, new demand pressures on

interest rates will be generated. As one looks across the history of business cycles, it is clear that interest rate movements have accompanied fluctuations in aggregate economic activity. Although the movements of interest rates and economic activity have not corresponded exactly in either timing or amplitude, it is reasonable to expect that economic expansion will--sooner or later--begin to generate credit demands in excess of supply, just as economic contraction in time dampens the demand for credit relative to the available supply.

The interest rate fluctuations that correspond to such demand-supply imbalances serve an essential economic purpose. For example, when the demand for goods and services races ahead of existing supplies, increases in interest rates help to limit the expansion of credit and thus check the upward pressure on product and labor markets.

In a period of strong economic activity, if all the credit desired were supplied at unchanged interest rates, the overall demand for goods and services would inevitably exceed the nation's capacity to produce. In such conditions, inflation could perhaps be suppressed for a time by rigid economic controls; but--if history over the centuries is any guide--I doubt if anything

in the world could prevent the eventual riot of inflation. Nor would we control interest rates in the end. Once it became clear that inflation was footloose, higher and higher premiums would be attached to the interest rates on which investors insisted and which borrowers were willing to pay. It is no accident that interest rates on 6-month business promissory notes have run to over 20 per cent in Argentina and over 40 per cent in Brazil during the past few years.

The new economic policy, as I have already explained, is capable of releasing powerful psychological forces that will tend to drive interest rates to lower levels. The outlook for interest rates over the next year or so nevertheless remains uncertain. We cannot be sure how quickly or to what extent the inflation premium on interest rates will be reduced. If economic recovery gains momentum and the Phase II program succeeds in holding down wage and price increases, opposite forces will be at work in the money and capital markets. On the one hand, the demand for credit on the part of the private sector will be larger, thereby tending to raise interest rates. On the other hand, inflationary expectations will become weaker, thereby tending to lower interest rates. We are moving into a period

for which there is no historical precedent, and little basis for gauging exactly how credit markets will adapt to the new circumstances.

Role of the Committee on Interest and Dividends

The Committee on Interest and Dividends will need to tread cautiously in these circumstances. It cannot ignore market conditions, for it would then run the risk of thwarting the overriding national objective of economic recovery and sustained non-inflationary growth. At the same time, the Committee can and should undertake surveillance of interest rates, particularly those that most directly affect the American family, in order to determine if they are unduly sticky--that is to say, by way of example, whether they are adjusting appropriately to whatever declines occur in the more flexible and competitive market interest rates.

In evaluating the role of the Committee, it should be recognized that credit markets are among the most competitive in our entire economy. Large financial institutions are, of course, a fact of modern economic life; but no single institution, or small group of them, is capable of dominating the market

for credit, partly because there are so many of both the large and small institutions. Moreover, the money and capital markets in the various parts of our country are closely connected. In this age of the automobile and telephone, most borrowers can readily move from one financial institution in their vicinity to another, or--in the case of large, nationally known borrowers--from virtually any bank or insurance company in the nation to any other or from any of these institutions to the open market. In turn, many financial institutions can shift their lending from one market to another, depending on the rate of return available to them. The same is true of savers.

The result is that the level of interest rates is highly responsive to changes in the underlying demand-supply conditions for credit. The structure of interest rates is also responsive. When interest rates in one part of the market decline, interest rates in other parts of the market generally follow along, although sizable variations in interest rate spreads are not uncommon.

The price flexibility that is so characteristic of financial markets is rarely found in product markets and practically never occurs in labor markets. These latter markets are subject to

all sorts of rigidities. Competition is less pervasive. Some of our industries are dominated by a few large firms. Large segments of the labor market are fenced off from effective competition by trade unions or governmental regulation. Even in the absence of unions, employee demands derive support from the impracticability, in most cases, of assembling a substitute labor force. Most product and labor markets are thus less sensitive than is the world of finance to changes in underlying demand and supply conditions.

To illustrate these differences, we need only recall the substantial decline in interest rates, particularly short-term rates, that occurred from early 1970 to mid-1971. During this period, wholesale prices, consumer prices, and wage rates continued to rise sharply, despite substantial unemployment and sluggish demand for the products of industry. Clearly, interest rates responded with promptness and vigor to basic market conditions. This cannot be said of wages or most product prices.

However, it is important to recognize that not all credit markets are equally competitive or responsive, and that some types of interest rates move sluggishly. These rates are often

termed "administered rates" or "conventional rates," but they are not administered in the sense of being determined by a small group that is insensitive to the surrounding financial environment. Rather, they are rates for which a continuous, impersonal process of bidding in the open market, such as characterizes U.S. Government securities and corporate bonds, does not exist.

The so-called administered rates--for example, on residential mortgages, for consumer credit, and on loans to businesses and farmers--generally fluctuate over a narrower range than market rates. These sluggish rates involve such factors as longer-term customer relationships or substantial costs of administration. Hence, they also generally lag behind the market; that is, they may not move until it seems clear that market rates have established a new trend and are not just going through an erratic or episodic fluctuation.

It is at this point that the new Committee can make its contribution. The main role of the Committee, as I see it, should be to speed up the adjustment of traditionally sluggish interest rates to movements in market rates. This may be especially important in the year ahead, when we expect a further reduction in the inflation premium on interest rates.

When and as rates in the open market move downward, administered rates should move more and with shorter lags than they have in the past.

For the present, the Committee intends to concentrate on those interest rates that most directly affect the American family, including residential mortgage and consumer credit rates. But it is not unmindful of other areas of sluggishness, and will therefore watch the behavior of rates charged by a variety of institutions to a broad range of customers.

In recent years, some of the "administered" or "conventional" interest rates have tended to show greater flexibility. For example, the prime loan rate charged by banks was reduced 11 times between March 1970 and March 1971, declining from 8-1/2 to 5-1/4 per cent. It subsequently rose moderately, and most recently, as you know, has again declined. Major banks have been relying increasingly on the money market as a source of funds, and interest rate changes in the money market consequently have a greater influence on key bank lending rates. Moreover, the business customers of commercial banks have become more and more aware of the open market as a source of funds; this, too, has increased the flexibility of bank lending

rates. Recently, a few banks have indicated that they intend to tie the prime rate to one or another of the open market rates.

Mortgage rates are also becoming more sensitive to competitive conditions. The periodic auctions by the Federal National Mortgage Association provide a means by which lenders can gauge more promptly the extent to which supply and demand pressures in the broad capital market are affecting the mortgage market. And the information on interest rates that will be gathered by the Committee on Interest and Dividends, once it is disseminated throughout the country, should likewise help to increase the sensitivity of a wide variety of sticky rates to underlying conditions.

In evaluating interest rate developments, the Committee does not intend to try to hold particular rates at levels that are not competitive. If, in the face of accelerating credit demands, an attempt were made to keep some interest rates down through the use of rate ceilings, lenders would tend to withdraw from the affected markets. They would place their funds in other activities where the returns that could be earned were not controlled, including the equity markets. Or they would send their money abroad. Or some individuals, trust funds, etc. would

lend their funds directly to borrowers within their reach, by-passing the financial institutions and the organized security markets that play such a major role in our economy by mobilizing capital for the use of all borrowers, small and large alike.

Let us never forget that while a legislature may impose an interest ceiling, it has no way of compelling the owner of investable funds to lend them out to anyone. Indeed, the threat posed by ceilings might in itself be sufficient to keep lenders from committing resources to areas that may eventually become subject to rigid ceilings.

Of course, some banks or other financial institutions could be expected, whether because of custom or legal restriction, to continue lending in markets subject to interest ceilings that are below the free market level. But the supply of credit to such markets would then be reduced, so that the still active lenders would be forced to ration their short supplies of credit by some means other than interest rates. In such a situation, they could also be expected to use various non-rate devices--such as compensating balances, cash payments similar to points on a mortgage, special fees, or equity kickers--that would serve to enhance the return on their money. The result would surely

be an erosion of freely-functioning credit markets as we now know them, and the substitution of less efficient, less equitable, processes of allocating the supplies of credit that remained available. Arbitrary attempts to control interest rates, either in selected areas or for the economy as a whole, must be rejected as inefficient, inequitable and, in the end, unworkable for all concerned.

True, some interest rates are now legally prevented from moving in ways that accord with underlying demand and supply conditions. Interest rate or usury ceilings apply, for example, to rates on consumer and conventional mortgage loans in most states, to rates on state and local securities in some jurisdictions, and to rates on Federally underwritten mortgages. In the past such ceilings have limited the flow of credit to these areas in periods of rising market interest rates; they represent a type of impediment that it would be well to avoid in the future.

The legislation before your Committee empowers the President "to stabilize interest rates and dividends at levels consonant with orderly economic growth." This language has the great advantage--should mandatory controls be required--

of not implying fixed ceilings; instead, it recognizes that interest rate levels must be appropriate to orderly economic growth, and thus leaves room for essential flexibility.

Let me hasten to add that the President's Executive Order, dated October 15, directs the Committee to undertake a voluntary program; that is, to "formulate and execute a program for obtaining voluntary restraints on interest rates and dividends." I am confident that this objective can be achieved without resorting to mandatory controls.

Since August 15, indeed over the past year and a half, interest rate developments have been generally salutary. However, not all interest rates have responded fully to market developments, and some have hardly moved at all. The Committee will seek to encourage downward adjustment of these rates, and it would certainly frown upon any premature upward move of rates that had previously been sluggish in moving down. There is every reason to believe that banks and other lenders will cooperate in our program on a voluntary basis, just as business corporations have fully accepted on a voluntary basis the need to hold dividend payments unchanged during the period of the freeze.

Nevertheless, the legislation before you does provide standby authority to control interest rates and dividends in the unlikely event that the voluntary program proves unsuccessful. The authority is comparable to that already granted the President with respect to prices, rents, wages, and salaries. "Stabilization" of interest rates in the legislative context refers, of course, to the regulation of particular interest rates. It does not relate to general fiscal and monetary policies, which must continue to play a vital independent role in our economic stabilization efforts.

I need add only a word here about dividends, which represent a less troublesome problem than interest rates in the context of a wage-price program. In general, the Committee believes that increases in dividends during the Phase II period should be limited in such fashion that expansion of dividend income will be equitably related to increases in the incomes of wage earners. Some exceptions may, of course, be necessary to facilitate the raising of capital for expansion, particularly by small businesses. The details of the voluntary program with respect to dividends have not yet been worked out. Meanwhile, the Committee has asked that dividends be maintained at levels that accord with the guidelines of the Cost of Living Council.

Concluding Comments

As I have said earlier, success in reducing the inflation premium built into interest rates will depend, ultimately, on the strength of our national will. It will depend on our ability to restrain the growth in average wage rates to a pace that is appropriately related to national productivity gains. It also will depend on reasonable price restraints. The full support and cooperation of business, labor, and the general public will be required in order to reach the objective of cutting the inflation rate in half by the end of 1972.

It is highly important to bear in mind that the whole program of restraint on wages and prices represents a temporary effort aimed at speeding the return to noninflationary conditions in a free economy. This goal requires that we conduct fiscal and monetary policies so as to avoid setting in motion forces that would lead to excessive aggregate demand on our resources and trigger still another round of inflation. Only if all of the policy instruments available to the government are working in harmony can the present anti-inflation policy succeed. Only then will interest rates move down to the more normal levels that we would all like to see.

Finally, let me say that it would be wise to use the opportunity granted us by Phase II to ponder dispassionately why our economy has become so prone to inflation, and why the fires of inflation, once started, are so difficult to extinguish. Has the structure of our economy changed so as to impart an increasing bias toward inflation? Are business or labor groups abusing their economic power to a larger degree than they did ten, twenty, or thirty years ago? If so, to what degree are our laws or regulations responsible for such abuses? Why did the normal growth of productivity come to a virtual halt toward the end of the 1960's? How can our governmental training programs, on which vast sums are being expended, be made more effective? What contribution can local productivity councils make to improvements in industrial efficiency? How can the advantages of computerized job banks be effectively harnessed? These are a few of the questions that we need to ask and try to resolve in order to help assure that the controls of Phase II, once dismantled, will not be needed again in our lifetime.