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Statement by

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I appreciate the opportunity to appear before this Committee. In my capacity as Chairman of the Committee on Interest and Dividends, I have certain responsibilities under the Economic Stabilization Act. Let me therefore say at once that I endorse extension of the Act for another year.

The performance of the American economy in recent years, as well as that of other industrialized nations, has persuaded me that there is a need for legislation permitting some direct controls over wages and prices. I do not think that resort to such controls will be required all, or even much, of the time. However, the structure of our economy--in particular, the power of many corporations and trade unions to exact rewards that exceed what could be achieved under conditions of active competition--does expose us to upward pressure on costs and prices that may be cumulative and self-reinforcing. In dealing with the immediate inflationary problem, it would not be safe to rely exclusively on the Government's management of aggregate demand policies.

This nation has already incurred heavy sacrifices, besides investing a great deal of time and energy, in the effort to bring inflation under control. Of late, a substantial measure of success has actually been achieved. Judging by comprehensive measures, the rate of inflation declined from about 5 per cent in the first half of 1971 to about 3 per cent in the latter half of 1972. As a result, private decisions concerning wages, prices, and investments are now being made in a more tranquil atmosphere.

Yet, a vestige of the old inflationary psychology remains, and public apprehension appears to be spreading that the inflation rate may once again accelerate. That concern is understandable in view of soaring food prices and the quickening tempo of economic activity. Over the past year and a half, economic recovery has been vigorous, and the prospects appear good for strong continuing expansion in the year ahead. In these circumstances, monetary and fiscal policies must necessarily play the basic role in keeping economic exuberance within bounds. But direct concern with the wage-price area cannot be neglected by the Government in the months immediately ahead if the economy is to be protected against the risk of renewed inflationary pressure.

The precise form that a controls program should take is more a matter of judgment. As I see the problem, good logic underlies the phase-by-phase evolution of the program that the Administration has followed. First came shock therapy through a freeze of prices and wages. This was followed by a program that subjected most of the nonfarm economy to mandatory controls, implemented with extensive rules of prenotification, reporting, and policing. Now we have moved to a phase in which more reliance is placed on self-discipline in abiding by rules of appropriate behavior. The Economic Stabilization Act has thus permitted an orderly evolution of the controls program.

The move towards greater freedom was, I believe, both necessary and desirable. With the passage of time, any rigid program of controls leads to some economic inefficiency and distortion, to some misallocation of resources, to increasing administrative burdens, and to growing inequities among various classes of employees, employers, and industries. In the end, incentives to constructive innovation and enterprise are damaged, and the basis for economic prosperity may be seriously weakened.

It was virtually inevitable, therefore, that the comprehensive controls of Phase II would in time give way to procedures that allow greater freedom in private decision-making. Some observers believe that effective control over wages and prices has been weakened materially by Phase III. Such a judgment strikes me as premature. In the first place, a major step forward has been taken by bringing trade union leaders back into the policy-making process. This was probably essential to continuation of an effective control program. Furthermore, several of the major areas of the economy that have been especially troublesome remain under strict mandatory control; and the rest of the economy previously covered by Phase II remains fully subject to established rules of restraint. I am inclined to think that self-administration will be respected by a large majority of economic participants. In any event, enforcement remedies remain available to compel adherence to the program in obdurate cases. The broad approach of Phase III thus appears to me to be quite reasonable, and it should be given a fair chance to show what it can accomplish.

As I have already suggested, Phase III is hardly a voluntary program. A mandatory dimension is, in fact, built into it. But I also want to remind the Committee that even entirely voluntary programs can at times prove as effective as their mandatory counterparts. This is most likely to happen when the objectives sought are widely accepted, the rules of the program are clearly understood, and ongoing performance is adequately monitored. The program of voluntary foreign credit restraint by banks and other financial institutions, which the Federal Reserve has administered during the past several years, is an example of excellent cooperation.

The experience of the Committee on Interest and Dividends, which was established under the aegis of the Economic Stabilization Act, is another example of a voluntary program which has thus far achieved practical results. On November 2, 1971, the Committee issued a guideline that allowed for no more than a 4 per cent increase in dividends per share in 1972. This guideline applied to approximately 7,000 of the larger business corporations, which were to be monitored by the Department of Commerce, and to 14,000 banks, to be monitored by Federal bank supervisory agencies. I can now report to you that adherence to the 4 per cent limitation by both financial and nonfinancial corporations has been nearly perfect.

As of the end of 1972, only 43 of the covered corporations had declared dividends in excess of the Committee's prescription--some, apparently, due to misunderstandings. Furthermore, practically all of the corporations in violation have now agreed to take the necessary steps to move into compliance. I might add that very few exceptions to the guideline and related interpretations have been granted by the Committee. As of the end of the year, only 67 requests for exceptions had been received, and 46 of these were denied.

This record of voluntary compliance contributed very materially to holding the increase in total dividend payments by domestic corporations to 3.6 per cent during 1972. This figure is far below the increase in most other categories of income payments.

Without the Committee's program, a much larger rise in dividend payments would undoubtedly have taken place. Our best estimate is that dividend payments in 1972 might well have been some $2 billion higher if it had not been for the Committee's program. One of the important results of this smaller dividend payout has been a reduction in business needs for external financing. Thus the dividend program, by moderating the demand for credit, has reduced upward pressure on interest rates. This, of course, redounds to the benefit of all borrowers--individuals and governments, as well as business corporations.

In view of the fact that the intent of Phase III is to continue a strong incomes policy, the Committee reaffirmed its 4 per cent dividend guideline on January 26. At the same time the Committee indicated that it was continuing surveillance of interest rates and earnings of financial institutions, and that it expected these institutions to continue cooperating with the program.

Since its inception, the efforts of the Committee to hold down interest rates have focused on institutional lending rates, often termed "administered" rates. These interest rates are administered in the sense that they change on the basis of institutional decisions. Traditionally, they have been less volatile than market interest rates. One reason for the smaller fluctuation of institutional rates is that to some degree they reflect relatively inflexible costs--items such as overhead, advertising, and rates of return paid on some types of funds. Another reason is that the policies of institutional lenders commonly reflect longer-run considerations, such as the maintenance of favorable relationships with their borrowing customers.

Institutional lending rates need to be distinguished sharply from the interest rates that are set in the open and highly competitive market for securities of both short and long maturity. In this market, interest rates change continuously in response to the shifting needs, preferences, and attitudes of large numbers of individual lenders and borrowers. In the upward phase of the business cycle, market interest rates usually tend to rise as credit demands grow, particularly when inflationary expectations are being generated by advances in costs and prices. In a weakening economy, on the other hand, market interest rates tend to fall. That is the way in which market forces normally express themselves, and it is important that they be permitted to do so. For any effort to keep market interest rates artificially low in a strong economy could have disastrous inflationary consequences and would, in the end, be self-defeating. And just as clearly, any effort to keep interest rates artificially high in a weak economy would run the risk of depressing economic conditions further.

During the past year, with the economy expanding vigorously and loan demands rising steadily, short-term market interest rates increased two to three percentage points from their early 1972 lows. But in large part because of the progress recently made in curbing inflation, longer-term market rates--those on corporate, State, municipal, and Treasury securities--remained rather steady, and on balance are only a little above their lows reached early last year. Moreover, interest rates of all types--short as well as long, market as well as institutional--are substantially below the peaks reached in 1969 and early 1970. And I might note, in passing, that interest rates in our country remain a good deal lower than in most industrialized nations.

The Committee on Interest and Dividends recognized from the start that it would be unwise as well as impractical to attempt to interfere with market interest rates. Hence, the main concern of the Committee over these past 15 months has been to see to it that the interest rates set administratively by our lending institutions are kept at the lowest practicable levels. Our initial objective was to see institutional rates reduced more promptly than in the past as the cost of funds to the lending institutions declined. More recently, as short-term market rates moved to a higher level, the situation of institutional lenders has changed. The main principle that needs to be observed now by financial institutions is that increases in lending rates should be made only when they can be fully justified on the basis of the cost of acquiring lendable funds.

The Committee has recently re-emphasized its concern about advances in interest rates charged by financial institutions. In particular, we wish to see moderation in institutional policies with respect to rates--such as those charged on various types of consumer credit and on home mortgage loans--that matter most directly to American families. We have urged financial institutions to hold these rates down as far as they reasonably can, and the record appears to indicate that they have generally done so. We have also urged banks to exercise restraint in adjusting such key institutional rates as the prime rate on business loans. In the Committee's judgment, higher marginal costs of funds from sensitive market sources should not be permitted to influence unduly the spectrum of rates charged, including the rates charged to business borrowers.

The Committee on Interest and Dividends recognizes, of course, that underlying circumstances in financial markets are always subject to change. Higher short-term market rates have meant higher costs of funds for some institutional lenders. Commercial banks, for instance, have had to pay successively higher interest rates to obtain money through such money market instruments as negotiable time certificates of deposit. Even so, the banks have thus far generally practiced moderation in adjusting upward their key lending rates. For instance, all banks that permitted the prime loan rate to float by use of a formula tying it to market rates have either abandoned the formula or modified it so as to ensure that any rise in the prime loan rate will lag behind increases in comparable open market rates.

It is the Committee's opinion that since the costs of most lending institutions have not been rising as rapidly as short-term market rates, any upward adjustments in lending rates should be so ordered that profit margins do not rise appreciably. It is for this reason that the Committee is now expanding its monitoring activity to include full attention to the costs and profits of banks and other financial institutions. When four banks announced on February 2 an increase in their prime rate, the Committee responded at once by requesting each of the banks to furnish complete information on costs and earnings, together with any calculations they may have made that justified the increase in their judgment. Every bank in the country was informed by letter of the Committee's action. And as you may have noticed, Mr. Chairman, three of the four banks that raised the prime rate have now restored this rate to its previous level.

The moderate success that the Committee has thus far had in its program of voluntary restraint on institutional lending rates rests in good measure on the comprehensive system of reporting that it has developed on interest rate developments. Financial institutions have cooperated fully in providing the necessary information.

We now have monthly reports from commercial banks on interest rates charged small businesses, interest rates on agricultural loans for feeder cattle operations and for other farm production purposes, and interest rates on various types of consumer loans--for the purchase of new autos, mobile homes, and other consumer goods, and also on personal loans and credit cards. These monthly reports have been collected on a consistent basis since the beginning of 1972. They indicate that consumer loan rates generally declined in the early months of the year and then edged upward. On balance, however, interest rates charged for loans on new autos and mobile homes dropped by about 1/4 of a percentage point in the course of the year, while rates in other categories showed little net change.

New data on consumer lending rates also have been collected monthly from auto finance companies and bi-monthly from other finance companies. These figures, too, show either little change or some net decline in rates, depending on the type of loan. Rates charged by dealers on used car loans are, however, a clear exception. They rose rather substantially during 1972, but are still close to their August 1971 level.

The mortgage data collected by other government agencies have been expanded at the Committee's request to provide more accurate and timely information on interest rates than had previously been available. Putting all the existing information together, it appears that home mortgage rates have edged up a little in recent months, but remain about 10-15 basis points below their August 1971 levels and well below their peaks in 1969 or 1970.

In view of the exuberant pace of economic expansion which we are now experiencing, I cannot assure you that interest rates will not move upward in the months ahead. As I indicated earlier, it would be dangerous to try to prevent increases in interest rates that are freely determined in highly competitive markets. Any attempt to do so would, in present circumstances, run the serious risk of excessive monetary expansion and an escalating pace of inflation.

I can and do assure you that the Committee will do everything in its power to prevent premature increases in institutional lending rates or increases that are inordinately large relative to changes in market rates. I must, however, draw your attention to the fact that institutional interest rates are, by and large, also competitively determined, so that there is less to be accomplished by governmental intervention than in the case of various product and labor markets. You therefore should not expect more from the Committee on Interest and Dividends than it, or any similar group, can usefully accomplish in practice.

Past experience of our own country and of other countries--notably in Latin America--shows clearly that interest rate levels are highest when and where inflation or the fear of inflation is most pronounced. There is no way to prevent this outcome, since investors generally become less and less willing to lend if it appears to them that they are likely to suffer a loss in purchasing power by the time the loan is repaid. But these are precisely the circumstances when businessmen are apt to be especially eager to borrow. It follows, as we move forward, that the behavior of interest rates, particularly in the long-term market, will depend very heavily on the success that we can achieve in ridding our economy of inflation.

In closing, Mr. Chairman, I want to emphasize once again my conviction that the very future of the American economy depends on getting better control of our stubborn inflationary problem. Early extension of the Economic Stabilization Act, and its effective implementation by the Administration, are essential. But much more than this is required. Frugality in government expenditures, prudence on the part of the private sector, and appropriate restraint in the conduct of monetary policy--all these are indispensable ingredients of an effective stabilization policy in 1973.

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