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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 once again with the Joint Economic Committee to present the views of the Board of Governors on the condition of the national economy.

The past year has witnessed a remarkable expansion of economic activity. The physical output of goods and services rose 7.6 per cent over the past four quarters, and production in the industrial sector advanced even faster. The number of persons employed in civilian jobs has of late averaged about 2-1/2 million above year-earlier levels. Last month, the rate of unemployment fell to 5 per cent, or nearly a full percentage point below the level of a year ago.

Economic expansion during the past year was also well balanced, and employment therefore recovered in practically all major sectors of the economy. Consumers have been spending freely on a wide array of goods and services. The housing industry has defied earlier predictions of an impending decline. Business expenditures for capital equipment have risen substantially. And inventory investment, a laggard in this recovery, has also joined the economic advance of late.

As we see the state of business, the current expansion has considerable momentum. Consumer buying and business investment

in fixed capital are both likely to continue their upward course. Business firms, moreover, will need to add substantially to their inventories in coming months to accommodate a rising pace of sales. A good increase in physical output during 1973 thus appears in prospect. As production increases, the demand for labor will grow, and we may look forward with some confidence to further declines in unemployment during 1973.

While we have been experiencing robust expansion in the domestic economy, our foreign trade has proved singularly disappointing. True, exports rose substantially last year, but the dollar value of our imports increased even more. The vigor of our economic expansion was a major cause of the rise in imports. Other factors were also at work, including the explosive increase in energy requirements which caused our oil imports to grow.

Our over-all international economic accounts have continued to be seriously out of balance. The Smithsonian agreement of December 1971 was recognized by all concerned as a temporary arrangement, but it was also felt that it would give the nations of the world sufficient time to rebuild the monetary system on a permanent basis. As events have turned out, less was achieved

through the Smithsonian agreement than we or other nations expected from it. Serious conversations on international monetary reform have been under way for several months, but they have gone forward much too slowly. Meanwhile, another monetary crisis developed in recent weeks. The reasons for its precise timing may be debated, but there can be no doubt about the underlying cause--namely, the huge continuing deficit in the balance of payments of the United States, which has had its counterpart in the persistent surpluses of other countries.

The progress we need in our international accounts is enormous, and the way to a lasting solution does not depend on us alone. The devaluation of the dollar announced last week, together with the realignment of exchange rates accepted by other countries, should prove helpful over the longer run. Prompt action is now needed to revise the par value of the dollar and to adopt new legislation to promote expansion of international trade and to help restore equilibrium in our international transactions.

In the months immediately ahead, opposite influences will play on our foreign trade. The currency realignment will have a perverse influence until demand patterns become readjusted to the new structure of exchange rates. On the other hand, the expansion

of economic activity abroad will tend to bolster our exports in coming months. Also, our underlying competitive position in world markets should improve as a result of recent trends in costs and prices in the United States and abroad.

In most industrialized nations, inflation last year was proceeding at a pace substantially faster than in the United States. Our own inflationary problem, though worrisome, has thus far been under better control. In the first half of 1971, prior to the imposition of wage and price controls, the rate of inflation was about 5 per cent, judging by comprehensive price measures for goods and services produced in the private sector. The inflation rate slowed to 3-1/2 per cent in the first half of 1972, and to about 3 per cent in the latter half of last year.

This moderation in the pace of inflation has resulted from reduced pressure of rising costs on prices. Unit labor costs in the private nonfarm sector rose last year by only 1.6 per cent, compared with 3.4 per cent in 1971 and 6.6 per cent in 1970. The improvement stemmed mainly from larger increments to productivity, but a somewhat slower advance in wages was also a factor.

The progress we have thus far made in moderating inflation is, however, insufficient. There is no room for complacency when the average level of prices is still rising quite rapidly, when it appears likely that productivity improvements will fall short of last year's fast pace, when wage rate increases--if we may judge from the closing months of last year--are becoming larger again, when imported goods are going to cost more as a result of the recent devaluation of the dollar, and when American families are facing sharply higher grocery bills.

The unhappy recent rise in food prices is especially disturbing. This should not, however, blind us to the remarkable accomplishment of the past year and a half--a period when price advances became smaller while real output and employment were growing very briskly. This is an unusual pattern of behavior in an advanced phase of a business-cycle expansion.

Let me turn next to the role that monetary policy has played in recent developments.

A year ago, as the Committee will remember, unemployment was still nearly 6 per cent of the labor force, and industrial production had not yet regained pre-recession levels. / With an effective wage and price policy in place, the central task of

monetary policy was to promote expansion in economic activity on a sufficient scale to reduce the gap between actual rates of production and our full employment potential.

There can be no doubt that ample availability of credit contributed materially to the expansion of economic activity over the past year. For example, the impressive rise in consumer purchases of new autos and other durable goods could hardly have occurred without a pronounced increase in consumer instalment credit. Again, the exceptional growth of residential mortgage loans contributed powerfully to sustaining new housing construction at record levels. I am also convinced that the stability of long-term interest rates strengthened investor confidence and facilitated the expansion of business capital investment; the weakness of this sector, it may be recalled, had seriously restricted economic recovery during 1971.

Early in 1972, monetary policy sought to make up for the shortfall in the growth of money balances in late 1971. The rate of monetary expansion was, therefore, high in the first quarter of 1972. As the year progressed, evidence accumulated that economic expansion was quickening and that increasing demands for credit were putting upward pressure on short-term market

interest rates. This gave rise to some concern about the market for longer-term securities. It nevertheless was clear that efforts to prevent a rise of short-term market rates would result in excessively rapid expansion of the monetary aggregates.

Federal Reserve policy therefore tolerated the rise in short-term market interest rates that began last March and has continued since then. By the end of 1972, yields on Treasury bills, commercial paper, Federal funds, and on other short-term market instruments had increased about two percentage points from their lows, and some further upward adjustment has occurred since the beginning of this year.

Past experience indicates that a rise in short-term market interest rates is usually followed by slower growth of the monetary aggregates. This was an objective of monetary policy during 1972, and the rate of increase in the narrowly-defined money supply-- that is, demand deposits plus currency in public circulation--did in fact moderate during the late summer and early fall of 1972. Late in the year, however, additions to money balances spurted to a pace well above what the Federal Open Market Committee desired.

The precise causes of the unusual increase in money supply last December are still somewhat elusive. One known factor is

that the revenue-sharing checks received by States and localities temporarily raised the cash balances of these governmental units. It may also be that a change during November in Federal Reserve regulations governing bank remittances for cash letters contributed to the spurt. In any event, the December bulge in money growth proved to be short-lived. This January, the narrowly-defined money supply showed no further increase.

Increases in the money stock are very uneven over time, and rates of increase must be measured over more than a few months to determine the thrust of monetary policy. Thus, the narrowly-defined money supply grew by 7.4 per cent from the fourth quarter of 1971 to the fourth quarter of 1972. This was actually a little less than the increase in real output of goods and services, and far less than the 11 per cent rise in the dollar value of output. If the money supply had grown at a significantly lower rate, we would probably have experienced smaller gains in real output and employment last year, and unemployment would be at a higher level now.

In view of the lag in the workings of monetary policy, the Federal Reserve did, however, deem it desirable to move gradually toward a less expansive monetary policy during 1972. In the first

quarter, the reserves for supporting bank-deposit expansion came entirely from open market operations. But as the year moved on, a sharp reduction occurred in the additions to nonborrowed reserves-- from a 12 per cent annual rate in the first half of the year to 2 per cent in the second. Member banks reacted to this more reluctant provision of reserves as they customarily do--that is, by borrowing more at the discount window. There are, however, limits to such a process. Bankers know that they cannot rely on these borrowings in more than limited amounts or for more than limited time periods.

Developments have thus been underway for some time that should result in somewhat slower growth of the monetary aggregates. The Federal Reserve has also taken other restraining actions. Late in November, the Board raised margin requirements to forestall excessive use of credit in the stock market, and we thereby also indicated our concern about potential inflationary developments. And in January, the discount rate was raised to bring it into better alignment with market rates of interest. This move served notice to the banking system and to the public at large that supplies of money and credit were being brought under a tauter rein.

The current economic expansion has entered a more sensitive phase, in which new problems may be encountered.

A substantial further increase of real output is needed to provide employment opportunities for a growing labor force, and to make possible further progress in reducing unemployment. However, with labor and capital resources being utilized more fully, the expanding demand for goods and services could begin to pull prices upward and thereby reinforce prevailing cost-push pressures. In the absence of monetary and fiscal restraint, excess aggregate demand might easily reemerge and touch off a new round of inflation.

This must not be permitted to happen. The hard-won gains our nation has made in the struggle against inflation must not be frittered away. To do so would sap the confidence of our people in the integrity of government. We must also be mindful of the fact that inflation is now being resisted abroad by more stringent monetary policies, and also by incomes policies in some countries. If the potential benefits of the new exchange rate realignment are to be realized, the rate of inflation in the U. S. must be reduced further. For monetary policy, these considerations indicate a need to practice greater moderation during 1973 in the provision of new supplies of money and credit.

The Federal Reserve will remain mindful, nevertheless, of its responsibility to support further gains in real output and employment. Success in that endeavor will mean continued expansion in business activity, and thus rising credit demands. Market interest rates may, therefore, rise further, as they typically do in the expanding phase of the business cycle. But it is my hope and expectation that sharp increases in long-term rates can be avoided.

I can assure this Committee of two things. First, the Federal Reserve recognizes that in order to keep the monetary and credit aggregates under good control, it will be necessary to avoid efforts to hold open market interest rates at artificially low levels. Second, the Federal Reserve does not intend to permit severe stringencies to develop in the credit markets, or to try to correct for every error in public or private policies.

The proper role of monetary policy in the achievement of our national economic objectives is a comparatively modest one. Monetary policy can help to establish a financial climate in which prosperity and stable prices are attainable. But it cannot guarantee the desired outcome; the task is much too large.

The course of fiscal policy certainly has a vital bearing on reaching our national economic objectives. It now appears that Federal budget outlays in fiscal 1973 will be held to \$250 billion--or some \$6 billion below what the staff of the Joint Committee on Reduction of Federal Expenditures estimated just a few months ago. This would be a welcome achievement. Furthermore, the proposed budget for fiscal 1974 calls for a balance between revenues and expenditures at full employment.

However, the Administration's budget for fiscal 1974 can hardly be called austere. After all, total outlays are scheduled to rise an additional \$19 billion or 8 per cent. The national interest would be well served in present circumstances if the Congress saw fit to stay at or below the expenditure limits proposed by the President. It is also highly important, as the members of this Committee well know, that Congressional procedures be reformed so that Federal spending can be brought under better control.

Early evidence of better control over Federal expenditures would go a long way toward assuring the public that excess aggregate demand will not reemerge in 1973 and later years. But there are times when overheating of the economy originates in the private sector. At such times, flexible fiscal tools can help to curb private spending.

Some months ago, the Federal Reserve Board urged the Congress to consider a variable investment tax credit as a means of improving the conduct of economic stabilization policy. The essence of the proposal is that the President be given authority to initiate changes in the investment tax credit. At the same time, Congress would retain its traditional control over taxes and act as a full partner in making the needed adjustments. For example, the President might be permitted to change the tax credit within a specified range--say, between zero and ten or fifteen per cent, subject to modification or disapproval within 60 days by Congress.

This proposal, the Board believes, would facilitate making the timely adjustments required for a more effective stabilization policy. Prompt action by the Congress on a flexible investment tax credit would make it possible to use this instrument, if it were needed, to curb the growth of business capital expenditures later on in this expansion.

Improved policies of managing aggregate demand, important though they be, will not of themselves suffice to assure prosperity without inflation. Structural reforms are also needed. Not a few of our corporations and trade unions now have the power to exact rewards that exceed what could be achieved under conditions of

active competition. As a result, substantial upward pressure on costs and prices may emerge long before excess aggregate demand has become a problem.

There is no easy path to meaningful structural reform. Genuine progress would require that we undertake to curb abuses of economic power by both business firms and trade unions, besides reappraising a host of laws and governmental regulations that interfere with the competitive process.

Let me turn, before closing, to the role that private policies must play to ensure that inflationary developments do not frustrate governmental efforts to promote prosperity without inflation.

Since August 1971 our nation has been engaged in a new effort to influence wage and price decisions through direct controls. In its present phase, greater reliance is placed on self-discipline in abiding by rules of appropriate behavior. Phase III, however, is hardly a voluntary program. Several areas of the economy remain under mandatory control. Furthermore, the President has indicated his firm intention to take whatever action may be necessary to achieve compliance with the objectives of the program. He has ample authority to do so under the Economic Stabilization Act.

Yet, in the final analysis, the workability of any form of controls in an economy as large and complex as ours depends on public acceptance of the need for controls and on cooperation of the participants in the program. Phase II was successful in moderating wage rates and prices because of the widespread support it received from the American public, including business firms and the trade unions. Phase III will enjoy a reasonable measure of success if that spirit of cooperation continues, and if labor and management join together to increase productivity and to hold down increases in wage rates and prices.

Our nation's financial institutions must also make their contribution if the stabilization program is to succeed. It will be in their own interest, as well as in the national interest, to manage their lending policies more cautiously in the months ahead. Any rapid rise in commitments for future lending, for example, would increase the exposure of individual financial institutions to a liquidity squeeze, and at the same time contribute to an inflationary round of spending by businesses and other borrowers. Wise bankers will shun the temptation that arises during a period of business expansion to step up their lending activities. If excessive extensions of credit are averted through exercise of prudence by lenders and borrowers, the need for strong monetary restraints will not arise.

In recent weeks, I have felt a sense of concern developing across the nation about the ability of the United States to deal with the problems that prosperity creates. This concern is understandable. We live in troubled times, and memories are still fresh of the damage produced by inflation during the latter years of the 1960's. But there is no need to be afraid of prosperity. Our national economic policies are now set on a course that promises to bring us closer to the goal of a prosperous economy with stable prices. If we persevere, as we must, that objective can be realized.