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Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking and Currency

House of Representatives

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I am pleased to appear before this Committee in my capacity as Chairman of the Committee on Interest and Dividends. In that capacity, I have certain responsibilities under the Economic Stabilization Act. Let me therefore state at the outset that I strongly support extension of the Act for another year.

Our economy is experiencing at present a robust upsurge in production and employment. Over the past year, industrial output has risen by 10 per cent, and 2-1/2 million additional persons have found employment in our nation's factories, shops, service enterprises, and governmental offices. These gains in employment and production have reduced substantially the margins of unused labor and capital. Skilled labor is already in relatively short supply in some lines of activity, and many manufacturing plants are now operating at or near their practical capacity. Increasing numbers of business firms are experiencing delays in the delivery of raw materials or component parts; and in some industries, inventories of finished goods have been reduced below desired levels by surging customer demands.

We may reasonably expect the expansion of real output to continue over the months immediately ahead, in response to the rapid pace of consumer spending and to business demands for additional inventory and for increased long-term capital investment.

A continuing expansion in output and employment is needed if we are to make further progress, as I believe we will, in reducing unemployment. Nevertheless, a major objective of monetary and fiscal policies in 1973 must be to slow down the growth of real output to a pace that is sustainable over the longer run. If the rate of real expansion does not moderate relatively soon, pressures on wage rates and prices will intensify, imbalances will develop, and conditions will be fostered that could lead in time to a downturn in economic activity.

I am convinced that our battle to curb inflation, and to establish the basis for a lasting prosperity, can be won. Prudent monetary and fiscal policies are essential to achieving that objective, and signs are multiplying that such policies will in fact be followed. The pace of monetary expansion has moderated significantly in recent months, and the President has just reaffirmed his determination to keep Federal spending within targeted budget levels. In dealing with the current inflationary problem, it would be inappropriate, however, to rely exclusively on governmental efforts to moderate the pace of aggregate demand.

A significant part of the rise in wage rates and prices over recent years has stemmed from sources other than the pressures of excess demand. The structure of our modern economy--in particular, the power of some large corporations and trade unions to raise prices and wage rates above the levels that would prevail

under conditions of active competition--exposes us to inflationary troubles that cannot readily be solved with monetary and fiscal tools alone. This problem is not confined to the United States. Other nations are experiencing similar and, in many cases, more pronounced difficulties with cost-push inflation.

The best way to combat inflationary forces that are structural in origin is to improve the functioning of labor and product markets, so that wage rates and prices of commodities and services behave more nearly as they would in a freely competitive system. Such improvements in our economy are badly needed, but the path to meaningful reform is long and arduous. I reluctantly conclude, therefore, that there is need for continuing legislative authority to permit some direct controls over wages and prices.

Our efforts to curb upward wage and price pressures through direct governmental intervention have undergone a natural evolution since August 1971. First came the shock therapy of a virtually complete wage-price freeze; next came a phase in which most sectors of the nonfarm economy were subjected to mandatory controls and explicit requirements with regard to prenotification, reporting, and policing; finally, the program was altered to allow greater freedom in private decision-making and to place more reliance on self-discipline in abiding by rules of appropriate behavior.

A gradual move towards greater flexibility was, I believe, a necessary and desirable characteristic of the control program, and the Congress acted wisely in providing the broad legislative authority that would allow the program to respond to changing economic conditions. With the passage of time, any rigid system of controls leads to some economic inefficiency and distortion, to some mis-allocation of resources, to increasing administrative burdens, and to growing inequities. In the end, incentives to constructive innovation and enterprise are damaged, and the basis for economic prosperity may be seriously weakened.

Recent sharp increases in major price indexes have given rise to concern that the move to Phase III in early January was inappropriately timed and perhaps unjustified. A careful reading of recent price movements, however, indicates that much of the recent worsening in the rate of inflation is not really connected with the transition from Phase II to Phase III. By far the most disturbing development has been the skyrocketing cost of meats, grains, and other food products. These increases have reflected special factors. The demand for foodstuffs has expanded sharply both here and abroad during the past year, while supplies have been adversely influenced by weather conditions. Similarly, the sharp rise over recent months

either at the consumer or wholesale level--over the next month or two. The critical questions about Phase III are these: Will it succeed in holding down wage gains in major bargaining contracts to reasonable amounts this year? Will the pace of wage rate increases in nonunionized industries conform to the guidelines? Will increases in the prices charged by large firms be held within limits that are clearly justified by rising costs? These questions cannot be answered confidently at present.

I would urge the Congress, therefore, not to write into the Economic Stabilization Act a specific form of control for this or that sector of the economy in which price behavior is most troublesome at the moment. It would be wiser to maintain flexibility in the legislative mandate, so that new factors and conditions may be dealt with administratively as they emerge. I believe also that administrative flexibility is by far the best course in the field of interest rates, which up till now have been subjected to restraints under the voluntary program supervised by the Committee on Interest and Dividends.

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

in prices of internationally traded commodities, especially industrial materials, stems from world-wide shortages of supply relative to burgeoning world demand. The recent devaluation of the dollar will undoubtedly bring some further increases in the prices of imported goods.

The Administration has already taken a number of steps to relieve upward price pressures on strategic commodities, and further measures are being considered by the Cost of Living Council. Import restrictions have been eased for meats and fuel, substantial sales from the government's stockpile of materials are being planned, and farmers have been encouraged to expand their plantings of crops and their grazing operations. The production of wheat, soybeans, and feed grains should, therefore, be substantially larger this year, and once prices of animal feeds ease, meat supplies will also tend to expand. Meanwhile, the ceiling on meat prices announced last evening by the President will help tremendously in curbing the rise in food prices. The index of food prices will therefore taper off, although some increases in the prices of consumer foods may still occur over the next few months.

In my judgment, the doubts that are now being expressed about Phase III cannot be resolved by focusing attention on the behavior of prices during the past two or three months. Nor will the effectiveness of Phase III in moderating cost-push pressures on prices be indicated conclusively by the behavior of prices--

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 must be distinguished sharply from the interest rates that are set in the open and highly competitive market for securities. 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.

Short-term market interest rates, after rising about 2 percentage points in the course of 1972 from their early-year lows,



have increased from 1 to 1-1/2 percentage points further thus far in 1973. These increases reflect the vigor of the recent expansion of our economy and the greatly increased demand for money and credit accompanying this expansion. Longer-term market interest rates--those on corporate, State, municipal, and Treasury securities--have shown a much less marked upward movement; they were essentially stable during 1972, on balance, and have risen by less than one-half percentage point so far this year. Moreover, interest rates of all types--short as well as long, market as well as institutional--are still well below the peaks reached in 1969 and early 1970.

The Committee on Interest and Dividends realized from the start that it would be both fruitless and counterproductive to attempt to interfere with market interest rates. Any effort to keep such rates artificially low in a strong economy could have disastrous inflationary consequences. For the only means of balancing supplies of lendable funds with the demands for them, in such an environment, would be to keep creating additional supplies of credit through monetary expansion. Hence, the Committee has not sought to influence market interest rates in any way. The Committee has, however, devoted close attention to institutional interest rates, and

has worked energetically to see to it that the rates set administratively by our lending institutions are kept at the lowest practicable levels consistent with the movements in market rates generally.

The Committee's initial objective was to encourage financial institutions to reduce lending rates more promptly than in the past as the cost of funds to the institutions declined. This was consistent with the philosophy of the economic stabilization program, which called on all segments of our society--business firms and wage earners alike--to forego for the sake of the general welfare some of the earnings that they might otherwise have realized. More recently, as short-term market rates have surged upward, some institutional lenders--particularly the larger banks--have found the cost of the funds that they acquire, as well as the general cost of their operations, going up sharply. But the main principle that needs to be observed by the financial institutions in the new situation remains unchanged: any increase in interest rates on their loans should be fully justified by the costs that the institutions incur in obtaining lendable funds.

The Committee has stressed from the beginning the importance of holding down the interest rates that matter most to American families--that is, the rates paid for home mortgage loans and consumer credit. The Committee has also urged banks to exercise

restraint in adjusting the interest rate charged on loans to prime business customers, since this rate tends to influence--especially in the larger banks--the entire lending rate structure. On February 23 the Committee specifically suggested that increases in interest rates on business loans should be decidedly less than for open market rates; that adjustments should be delayed until it became clear that the increase in open market rates was not merely a temporary phenomenon; and that, if any rise in the prime rate occurred, special moderation should be observed in any adjustments of interest rates charged to small businesses and farmers as well as to homebuyers and consumers.

The Committee on Interest and Dividends recognizes, of course, the need to take account of changes that occur in the underlying circumstances of financial markets. In the last week of 1972 and in February 1973, the prime loan rate charged by many banks was lifted, first to 6 and then to 6-1/4 per cent. But short-term market interest rates were rising still more rapidly, under the pressure of strong short-term credit demands from business. With the prime rate lagging behind, virtually all of the enlarged credit demand fell on banks. Business loans at banks rose at an extraordinarily rapid rate during the first two months of this year.

A sizable part of this increase represented a diversion of borrowing from the commercial paper market. Still, the basic strength of the demand for business credit is indicated by an annual rate of expansion approximating 30 per cent in the combined total of business borrowing from banks and the commercial paper market.

The fact that the prime rate has recently been below open-market rates, therefore, has been encouraging an excessive and potentially unhealthy expansion of bank credit. The upsurge in bank lending, moreover, has involved a subsidy to large business borrowers, who have been calling upon banks to honor previous loan commitments tied to the prime rate. This has the effect of funneling credit to the sector that is especially able to afford higher interest rates in a period of surging economic activity. And if the increase in bank lending to large corporate customers lasted many more months, it could lead to a diversion of bank credit from other groups--homebuyers, consumers, small businesses, and State and local governments.

My discussions last week with the banks that had just announced a 6-3/4 per cent prime loan rate led to a suggestion that would correct this inequitable situation--namely, the establishment of a dual prime rate. One rate would be applicable to large, widely known corporations which have access to the national money and capital market, and this rate could respond flexibly to changes in

open market rates. Thus, large businesses would sustain interest costs on bank loans commensurate with their costs on alternative sources of funds. The prime rate and the entire structure of rates charged to smaller businesses, on the other hand, would not move with the prime rate for large customers. Special moderation could thus be observed with respect to loans to smaller businesses which rely principally on local banks and have only limited access to other sources of credit.

As you may know, I have urged bankers to give prompt consideration to this suggestion as a way of enabling the credit markets to function efficiently while still maintaining effective restraint on the interest rates charged for small business loans. I have also reaffirmed the great public importance of continuing to practice moderation in interest charges to farmers, homebuyers, and consumers.

Banks appear to be in the process of developing policies in the spirit of the proposal for a split prime rate. Some banks are considering plans to offer different prime rates on loans of different sizes, with one rate for smaller loans--\$350,000 or less, for example--and another more flexible rate for loans above that amount. Other banks are considering the introduction of a graduated prime

rate, under which some stated amount of a business loan would be subject to a specified interest rate and the excess above this amount would be at the higher rate generally charged by money-market banks. And still other banks are proposing that one rate apply to their local customers and the other, higher rate be charged to customers outside their community.

The Committee on Interest and Dividends is looking into these various plans, and its staff is studying the criteria by which large and small business borrowers might be differentiated. It is still too early to judge what can work well in practice. In the meantime, the banks that had announced a prime lending rate of 6-3/4 per cent have, at our urging, rolled back their prime rate to 6-1/2 per cent.

I am hopeful that a way can be found in the near future that will permit more flexibility in the rates charged to large borrowers while maintaining effective restraint on interest rates for smaller businesses. An additional principle, of course, must also be kept in mind. Regardless of the rates that are charged on very large loans, considerations of equity will require that the banks and other institutions continue to extend adequate credit to homebuyers, smaller businesses, consumers, and farmers.

On balance, I can report to you that the Committee thus far has had a good deal of success in restraining the upward movement of institutional lending rates. New data, collected as a part of the Committee's surveillance program, show that the rates charged on consumer loans by banks and finance companies have changed little or actually declined since January 1972. Rates on bank loans to small businesses and farmers have increased by less than one-half per cent over the same period. And rates on new home mortgage loans, although they have drifted gently upward in recent months, remain slightly below their pre-Phase I levels and substantially below their highs reached in late 1969 and early 1970.

I can report also that adherence to the dividend part of the Committee's program of voluntary restraint has been nearly perfect. In November 1971 we issued a guideline allowing no more than a 4 per cent increase per annum in dividends per share; this percentage limitation has been extended to cover dividend payments in 1973. The guideline applies to approximately 7,000 of the larger corporations.

The excellent--indeed, truly extraordinary--record of compliance with our voluntary program on dividends was a major factor in limiting the increase of total dividend payments by domestic

corporations to 3.6 per cent last year--a percentage substantially below the increase in most other categories of income. One of the by-products of this reduced dividend pay-out has been a significant reduction in business needs for external financing--by some \$2 billion last year. As a result, the dividend program has reduced somewhat the upward pressures on interest rates over this period, to the benefit of business and other types of borrowers alike.

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 very dangerous to try to prevent increases in those interest rates that are freely determined in highly competitive markets. Any attempt to do so would, in present circumstances, simply result in excessive monetary expansion and an escalating pace of inflation.

I can and do assure you that the Committee will continue to do everything in its power to see to it that substantial restraint is practiced by lending institutions with respect to the interest rates that bear most directly on our families and small businesses. 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.

In that context, let me counsel strongly against mandatory controls or ceilings on institutional lending rates. The inflexibility imposed by a mandatory program could have the most serious consequences for the American economy. First, it could easily lead to a renewed large outflow of dollars to foreign money markets, where higher interest rates may be obtained. Second, artificially low interest rates could lead to a drastic reduction in lending by our financial institutions, to the detriment of all businesses, home-buyers, and consumers needing credit. Third, a drying up in institutional sources of credit would lead to the development of black markets for credit, where the interest rates demanded may far exceed the highest we have experienced at any time in the postwar period. In short, the financial and economic distortions that could be caused by interest rate ceilings far exceed any possible benefits that might be gained.

In conclusion, the Committee on Interest and Dividends has played, and can continue to play, a supportive role in our current

effort to contain inflation. In waging war against inflation, sacrifices must be spread as evenly as possible over the whole of society-- including financial institutions. The Committee can see to it that financial institutions understand the need to avoid disproportionate profits at a time when governmental policy is striving to restore general price stability to our troubled economy. It can see to it that American families, small businessmen, and farmers do not pay excessive rates of interest relative to the costs of financial institutions. It can see to it that dividend recipients share in the moderation of income growth that is necessary to put our economy back on a noninflationary footing.

But the role of the Committee and, for that matter, the whole effort of the Cost of Living Council, should not be exaggerated. Success in dealing with our nation's stubborn inflationary problem depends fundamentally on frugality in government expenditures, on appropriate restraint in the conduct of monetary policy, and on prudence in the spending behavior of the private sector. Early extension of the Economic Stabilization Act will help buttress these fundamental policies and seems to me an essential need in the current environment.