

For release on delivery  
Wednesday, June 6, 1973

Some Problems of Central Banking

Address by  
Arthur F. Burns  
Chairman, Board of Governors of the Federal Reserve System

before the  
1973 International Monetary Conference

Paris, France

June 6, 1973

The advent of the 1970's has not diminished the range or difficulty of the problems that central bankers face. In the international area, relationships among economies have been undergoing rapid change, and our governments are now actively seeking to develop new international rules to guide their future conduct in the spheres of money and trade. As central bankers, we have inevitably become involved in efforts to achieve urgently needed reforms of the international monetary system. We have also had to wrestle anew with problems of recession, economic overheating, and the stubborn persistence of inflation.

Today, I want to focus my remarks on the problem of achieving greater stability in the performance of our domestic economies. There is no more crucial need for the stability and welfare of our economies than to find more effective methods for dealing with inflation and its causes. Restoration of international financial order also depends heavily on our handling of this problem. The policies that are needed to halt inflation, without at the same time plunging our nations into economic stagnation or recession, extend beyond the normal province of central banking. Skillful management of monetary matters nevertheless remains an

indispensable ingredient in reaching the objective of non-inflationary growth that we all seek.

Since the end of World War II, our economies have developed a disconcerting bias toward inflation. A variety of influences -- social, political, and institutional -- have been at work here. But there can be no doubt that the speed and vigor with which governments tend to deal with recession, their considerable success in this endeavor, and their reluctance to act with similar decisiveness to curb economic booms, have contributed materially to the world-wide upward trend of the price level and the persistence of inflationary expectations.

Monetary and fiscal policies for managing aggregate demand now bear, and must continue to bear, the main responsibility for regulating the over-all performance of our national economies. At times, the level or pace of total economic activity will continue to call for restraining policies, and at other times there will be need for stimulus. But I must caution that experience suggests that we will need to embark on policies of active stimulation with greater care, unless we subdue the natural inclination to stay too long with such policies. The ability and the will to make timely shifts in the thrust of fiscal and monetary

policies are of the utmost importance if these policy instruments are to play a more constructive contracyclical role.

We need also to recognize that skillful, timely, and flexible use of demand management policies may not suffice to achieve satisfactory economic performance. To be sure, total spending in the economy can be slowed through monetary and fiscal measures. But under the institutional conditions that now prevail in many of our countries, shifts in these policies have a much stronger and more prompt effect on real output and employment than on the pace of inflation. The persistence of rapid advances of wages and prices in the United States and other countries, even during recent periods of recession, has led me to conclude that governmental power to restrain directly the advance of prices and money incomes constitutes a necessary addition to our arsenal of economic stabilization weapons, to be used occasionally -- but nevertheless vigorously -- when needed.

There is another difficulty in relying exclusively on broad monetary and fiscal policies for combatting cyclical fluctuations. Over-all restraint, it is true, will in time slow any exuberant expansion. It may not, however, curb sufficiently or in timely fashion the sectors of demand that are leading to economic imbalance, and thereby set the stage for later economic trouble.

Over-all restraints that are sufficient to curb expansion in aggregate economic activity may do so by inducing sizable declines promptly in some areas, such as housing, and yet have slight effect for some time in other areas, such as business investment. This is particularly likely to be the case when reliance is placed mainly on monetary policy, and hence on sharp changes in credit conditions, for purposes of economic stabilization.

Throughout business cycle history, the major force making for economic instability has been the rather large fluctuation characteristic of business investment. At times, of course, the spending and taxing policies of government have been a source of economic trouble, especially in connection with wars and their financing. On occasion, also, large changes in the spending propensities of consumers have played their part in carrying aggregate activity to unsustainably high, or unacceptably low, levels. But it is in the pronounced changes of the investment plans of business firms, with respect both to their fixed capital and inventories, that much of the cyclical instability of advanced industrial economies has originated.

Business investment is, of course, vital to the growth in productivity, and the improvement in material welfare, to which all nations aspire. Over the long run, incentives to invest therefore need to be enhanced. But it would be far better if a high average level of investment could be achieved without the sizable fluctuations that have characterized the past. The general economy would benefit from a reduction of this source of instability. Business enterprises would also benefit from a more regular pace of investment, since they would thus avoid a concentration of expenditures at times when financing costs are high, when the capabilities of suppliers are strained, and when delivery and installation dates become more uncertain.

In view of our continuing problems in achieving economic stability, we must persist in the search for new and more refined tools of stabilization policy. Ideally, these measures should be of the kind that can be introduced or removed quickly and that will affect private spending decisions rather promptly. Many countries have recognized this need, and we at the Federal Reserve have sought to profit from their experience and studies, as well as from our own research.

Last year, for example, the Federal Reserve Board completed a study of ways in which the housing industry could be provided a degree of insulation from the fluctuations brought on by sharp changes in credit conditions. One of our major conclusions was that more stability in residential construction would require less instability in business investment. Toward this end, we proposed that consideration be given to the use of a variable investment tax credit. When contracts or orders for new plant and equipment are advancing too rapidly, the tax credit could be reduced, and when such investment is lagging, the tax credit could be raised; thus providing a direct cost incentive for moderating cyclical movements in this area.

I continue to believe that the concept of a variable tax incentive to business investment has merit. Because of our need in the United States to encourage greater productivity, however, I would now recommend that the tax credit remain in effect continuously and that it at no time drop to zero. It could vary, perhaps, between 3 or 4 per cent and 15 per cent, depending on economic conditions. It would be important also to retain a decisive role for the Congress in determining the specific rate of tax credit. This could be done by empowering

the President to initiate changes in the investment tax credit, but making it subject to veto or approval -- and perhaps also some modification -- by the Congress within a 45 or 60 day period.

In recent months, the Federal Reserve has faced the problem of dealing with a rapidly escalating demand for bank credit, even though the monetary aggregates, by and large, have grown at a moderate pace. The upsurge in bank credit has been associated mainly with the demand for business loans, and it has been largely accommodated by the banks through the issuance of certificates of deposit in the money market.

Accordingly, the Board in mid-May announced a new restrictive action aimed specifically at this development. Since May 16, any further increase in bank issues of large certificates of deposit or similar money market instruments, over a base of \$10 million or the amount then outstanding, whichever is larger, is to be subject to an additional reserve requirement, presently set at 3 percentage points. At the same time, any additional funds obtained abroad by U. S. banks for domestic purposes became subject to reserve requirements on a comparable basis, and the remaining interest rate ceilings on large certificates of deposit were suspended.

The new marginal reserve requirement will raise the cost incurred by banks in obtaining additional funds through the money market for the financing of loan expansion. Banks doing so will have the use of only 92 per cent of the proceeds, rather than the 95 per cent that they had before. The purpose of the marginal reserve requirement is to restrain bank lending to business on a market-oriented basis, so that rationing of funds by the banks to their large business customers may be accomplished through higher costs, rather than by the imposition of arbitrary and inflexible interest rate controls. We expect that the result will be to moderate the willingness of banks to accommodate their customers through this source of financing. If it fails to do so sufficiently, we are prepared to consider additional actions that will limit further the availability of the funds that banks have at their disposal.

I have urged bankers in the United States to discipline the pace at which they are extending credit, in the interest both of our economy's present need and of sound banking practice. I repeat that appeal today. In doing so, I recognize that earnest efforts by commercial banks to moderate their rate of credit accommodation will not, by itself, be a sufficient remedy. It is no less important that our business leaders recognize the

need to limit their investment plans for the time being, and thus restrict their requirements for external finance, whether from the banks or the money and securities markets. Moderation in the growth of bank credit will be of little avail if the result is merely to augment open-market financing of an unsustainable increase in business spending.

In times like these, it is also necessary that public expenditure in the United States be restrained to the maximum extent feasible. It is necessary that our government seek strenuously to achieve balance, or actual surplus, in its income relative to its expenditure. And as far as the Federal Reserve is concerned, it is more necessary than ever that we keep monetary expansion down to a moderate pace, while we at the same time avoid the kind of constriction in credit markets that could lead to recession and the certainty of large stimulative measures later on. We must avoid serious overheating of the American economy now, and we must try to curb our inflation through methods that will not add to future economic instability. With reasonable cooperation by all leading groups in our society, I am confident that we can achieve these goals. This is of critical importance to the United States and also to the world at large.

\* \* \* \* \*