For release on delivery

Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

August 3, 1973

I am pleased to meet once again with the Joint Economic Committee to present the views of the Federal Reserve Board on the state of our national economy.

In my testimony before this Committee in July 1972, I presented evidence of a significant strengthening in the pace of economic expansion. Recovery was finally underway in business capital formation, residential construction was moving up briskly, and consumer buying was continuing its marked uptrend.

The rate of expansion in aggregate economic activity rose further in the closing months of 1972, and rapid expansion continued on into 1973. The physical volume of production of goods and services advanced by more than 6 per cent during the year ending this June, while the output of the nation's factories and mines rose 9 per cent.

These large increases in production were accompanied by a growing demand for labor as well as by sizable increases in average output per manhour. Civilian employment rose by nearly 3 million persons during the past 12 months, and the

rate of unemployment dropped from 5.6 per cent to 4.7 per cent of the labor force.

The pattern of growth in economic activity has been similar in many respects to that of earlier cyclical expansions. Thus consumers, besides spending rather freely out of their increased incomes, borrowed heavily to finance purchases of autos, furniture, and other durable goods. Business firms, meanwhile, enlarged their plant facilities and stepped up their acquisition of new and more modern equipment. They also increased their inventories; but as their sales often ran ahead of expectations, the over-all ratio of stocks to business sales actually declined.

These domestic forces of economic expansion were reinforced by a strong upsurge in export orders. This June, the annual rate of our merchandise exports was $21 billion larger than a year ago -- a rise of 44 per cent. After allowance for price increases, the rise was still close to 30 per cent. The extraordinary increase in foreign demand for our products has had substantial consequences both for production and prices. The dollar value of our imports also rose rapidly during the past twelve months; but the increase of about $16 billion in the

annual rate reflected in large part the rise in import prices, and this rise too left its mark on our general price level.

As this Committee is well aware, prices in the United States have risen very sharply since the beginning of this year. In fact, inflationary pressures over the past 6 or 7 months have been stronger than at any time since the Korean War.

In view of the strong cyclical expansion in production and employment, it would have been difficult to avoid an appreciable upward tilt of the price level in the best of circumstances. But as the tides of fortune would have it, several factors of an unusual character combined to impart to our inflationary problem a new and more ominous dimension.

First, the wage and price policy of Phase III made it easier to pass on rising costs to product prices and also, here and there, to widen profit margins which had been suppressed previously.

Another and far more important development was the coincidence of strong business expansions in the United States and other countries. To a degree without parallel since World War II, economic activity has recently been booming in virtually all industrial countries. For example, industrial production during

the past twelve months increased about 7 per cent in Belgium and the Netherlands, 8 per cent in West Germany, 9 per cent in France, Canada, and the United Kingdom, and 19 per cent in Japan.

With production increasing rapidly in the industrial world, there has been a swelling demand for industrial materials, machine tools, component parts, and capital equipment -- goods for which this country is a major source of supply. The boom in other countries has thus had a considerable impact on our domestic markets.

The inflationary dimension of this world-wide boom became visible after mid-1972, when wholesale prices began to increase sharply in many countries. During the past year, prices at wholesale rose on the average about 6 per cent in West Germany, 9 per cent in France, 11 per cent in Japan, and 13 per cent in Canada -- to mention a few examples. Toward the end of 1972, the rise in wholesale prices generally accelerated, and rates of inflation are now even higher than these year-to-year changes indicate.

The advance of prices has been particularly large for internationally-traded commodities, such as agricultural products and industrial materials. The rise in dollar prices of

Sharply higher prices of industrial materials have also been a prominent feature of the recent accelerated pace of world-wide inflation. In the past 12 months, wholesale prices of crude industrial materials rose on the average by 18 per cent in our country, and prices of intermediate materials increased 8 per cent. By contrast, wholesale prices of finished goods other than foods rose about 6 per cent.

Prices of industrial materials typically rise faster than those of finished goods during a period of cyclical expansion -- and the more so when rapid economic growth occurs simultaneously in many countries. Recent price developments, however, have also been aggravated by severe capacity constraints on the production of major industrial materials. Calculations by the research staff of the Federal Reserve Board indicate that in the first half of this year the rate of capacity utilization in major materials-producing industries -- including petroleum refining, production of aluminum, steel, cement, synthetic fibers, paper, paperboard, and the like -- was at the highest level since the second quarter of 1951.

In many of these industries, there has been very little growth of productive capacity in recent years. Environmental

these goods has been much larger than in German marks, Swiss francs, or Japanese yen, because of the huge decline in the purchasing power of the dollar over these and many other foreign currencies. The depreciation of the dollar thus immediately affected our price level; but its indirect effects were probably much larger, first, because rising import prices led to some substitution of domestic products and thereby served to raise their prices, second, because a cheaper dollar also gave a sharp impetus to exports and thereby further reinforced the pressures of demand on our resources.

The most troublesome aspect of the recent worsening of inflation in the United States and other countries has been the rapid run-up in food prices. At the very time when the demand for foodstuffs was rising in response to the world-wide expansion in incomes and employment, world agricultural production was restricted by unusually bad weather conditions in a number of countries. In the United States, moreover, the restrictive effects on output of earlier agricultural policies were reinforced by disappointing crop harvests and some decline in production of beef and pork. The resulting rise in our food prices was compounded by swelling export demands for agricultural commodities.

controls have held up construction of new plants, have led to shut-downs of some existing plants, and have prevented the activation of some older standby capacity. Moreover, investment in new capacity was discouraged by the relatively low profits of our domestic non-financial corporations between 1966 and 1971. Productive capacity in the paper industry, and also in petroleum refining, appears to have grown less than 2 per cent per year during the past several years. In the cement industry, productive capacity has shown little or no growth over the past 5 years. Not a single new cement plant has come into production during the past year and a half, and only one new petroleum refinery has been opened since 1969.

These are sobering facts. Lack of sufficient attention to investment incentives in these industries, and to the special problems they face as a consequence of environmental control programs, has resulted in shortages of many basic materials needed by American industry to expand production. For want of steel, or aluminum, or industrial chemicals, or adequate fuel supplies, business firms in various lines of activity have been unable to increase production rapidly enough to meet the demands of their customers; unfilled orders have mounted, and delivery delays have lengthened. Price pressures originating

in short supplies of major materials have thus been generalized to semi-finished and finished goods.

In short, our inflationary problem this year has arisen in substantial measure from sources well beyond the influence of domestic monetary and fiscal policies. A world-wide boom has been underway, the dollar has been devalued, and both agricultural products and basic industrial materials have been in short supply. Violent price increases that stem from such sources cannot readily be handled with customary weapons of economic stabilization policy.

It now appears, nevertheless, that a somewhat slower rate of growth in aggregate demand late last year and in the first quarter of 1973 would have been desirable. Consumer spending rose faster than we at the Federal Reserve Board had foreseen, and I believe much more than most business firms had expected. In the fourth quarter, the growth of real GNP reached an annual rate of about 8 per cent, and this rapid pace continued in the first three months of 1973. So high a rate of expansion is welcome when most lines of activity have sizable unutilized resources at hand, but it raises problems when basic industrial materials are in short supply and when skilled labor is becoming harder to obtain.

Both monetary and fiscal policies moved in the right direction last year. In retrospect it appears, however, that restraint should have been somewhat greater. True, efforts to hold the line on Federal budgetary expenditures were successful. Contrary to widespread expectations, the President's objective of holding Federal expenditures down to $250 billion was not only reached but in fact exceeded. Actual budgetary outlays in the fiscal year just ended fell short of $247 billion. Nevertheless, a deficit of over $14 billion is still huge; it was particularly inappropriate at a time of rapidly advancing prosperity; and it played its part in stimulating private spending and aggravating price pressures.

Monetary policy began to move in the direction of restraint in the spring of 1972, when mounting pressures in financial markets were allowed to express themselves in higher short-term interest rates. As the year progressed, it became evident that the rise in short-term interest rates was not accompanied by moderation in growth of the major money and credit aggregates to the extent desired. The Federal Reserve, therefore, began to move more aggressively toward monetary restraint last fall. Margin requirements on common stocks

were raised, and what is far more important, open market operations were directed toward reducing sharply the rate of expansion in non-borrowed reserves of commercial banks. Since the need for bank reserves was growing rapidly at that time, the rise in the Federal funds rate accelerated, and member banks turned increasingly to the discount window as a source of additional reserves.

By the end of last year, member bank borrowings reached an unusually high level. In January, therefore, the Board approved the first in a series of higher discount rates with a view to discouraging reserve expansion through the discount window and inducing the commercial banks to restrain loan expansion. Altogether, the discount rate has been raised six times this year to its present level of 7 per cent -- a rate that our financial markets had not experienced in over fifty years. In May, the Board also raised the reserve requirements applicable to any further increase in the amount of large-denomination certificates of deposit (CDs) outstanding at member banks. And the Board took the further and, I believe, unprecedented step of addressing a request to non-member banks and agencies or branches of foreign banks to accept voluntarily the

higher reserve requirements imposed on member banks. In late June reserve requirements were again increased -- this time on demand deposits of member banks.

Since these restraining moves were taken during a period when credit demands were unusually heavy, interest rates on short-term securities increased sharply, and long-term rates followed suit -- although with a lag and to a much smaller degree. The yield on 3-month Treasury bills has been above 8 per cent of late, in contrast to a level of 5 per cent at the end of last year and 4 per cent at this time a year ago. And the prime rate of interest on bank loans to large businesses has increased since the first of January from 5-3/4 to 8-3/4 per cent.

Some classes of loans and securities have remained sheltered thus far from the strong upward pressures in markets for short-term securities. For example, rates on consumer instalment loans are on the average no higher now than they were six months or a year ago. Rates on loans to small business firms appear to have increased over the past six months by little more than 1/2 percentage point -- in contrast to a rise of 3 percentage points in the prime rate on large business loans.

Mortgage loan rates, however, are up sharply in recent weeks, although they are still below their earlier peaks in 1970.

All in all, existing interest rates in this country are clearly much higher than any of us would like. Some advance of interest rates is unavoidable during a business-cycle expansion, particularly when the economy is booming -- as it has of late. But the underlying reason for the high level of interest rates is the persistence of inflation since 1965. Inflationary expectations have by now become fairly well entrenched in the calculations of both lenders and borrowers. Lenders commonly reckon that loans may be repaid in dollars whose real value will deteriorate because of inflation, and they therefore tend to hold out for nominal rates of interest high enough to ensure them a reasonable real rate of return. Borrowers, on their part, anticipating repayment in cheaper currency, are less apt to resist rising costs of credit.

The marking up of nominal rates of interest during periods of inflation is a process that is much too familiar to economic historians. Businessmen and laymen have also seen its recent manifestation in other countries. If I accomplish nothing else this morning, I want to emphasize the simple truth

that inflation and high interest rates go together and that both the one and the other pose perils for economic and social stability in our country.

I wish I could offer hope that the general level of interest rates will soon decline. I cannot in good conscience encourage that thought. A lasting downward movement of interest rates cannot be reasonably expected until better control is gained over the forces of inflation. Some downward movement of short-term rates may occur, however, once we achieve a larger measure of success in moderating growth of the monetary and credit aggregates. Progress has been made in this effort, but less than we had hoped for.

In the first quarter of this year, growth of the narrowly-defined money supply -- that is, currency in circulation plus demand deposits -- slowed abruptly. At the time, it appeared that transitory factors were reducing the public's demand for money, but that a substantial bulge in the money stock would probably soon develop. We therefore persisted in moving further toward monetary restraint.

As events turned out, the growth of currency and demand deposits during the second quarter exceeded our expectations. Taking the two quarters together, the annual rate of growth

averaged 6 per cent. This was well below the growth rate during 1972, but greater moderation was needed.

Strenuous efforts were made by the Federal Reserve to resist the resurgence of monetary expansion during the second quarter, and these efforts are continuing. We could, to be sure, have exerted still stronger resistance to that upsurge in money demand. Had we done so, we would have run the risk of stimulating far larger increases in interest rates -- increases of a magnitude that might well have created serious turbulence in financial markets.

In any event, indicators of monetary and credit expansion other than the narrowly-defined money supply indicate that our restrictive policy was beginning to bear fruit in the second quarter. For example, the annual growth rate of total bank credit declined to about 10 per cent, compared with rates of increase of over 15 per cent in the previous two quarters. Bank loan expansion, particularly loans to business, slowed materially, as lending policies at banks across the country tightened.

These are characteristic signs of developing restraint in the money and credit markets, and I therefore expect growth in the narrowly-defined money supply to slow in the very near future. Let me make clear, however, that if the restrictive

actions already taken by the Federal Reserve do not reduce growth of money and credit to an acceptable rate, further measures will be adopted as needed.

We have thus far avoided a severe stringency in credit markets. There has, however, been some loose talk of an impending credit crunch, which I believe is traceable to failure to appreciate the significance of what has been done to minimize the likelihood of any such event. Let me therefore try to clarify this vital dimension of the credit market.

Some weeks ago, the Board suspended the remaining ceiling rates on large denomination CDs. As a consequence, the situation that banks now face is very different from that of 1966 or 1969, when inability to bid for CD funds forced banks to act abruptly and deny access to credit to a wide range of borrowers. Under present circumstances, individual banks can obtain funds in the CD market if they --and ultimately the business firms that borrow from them-- are willing to pay the price. Of late, as the cost of CD funds has risen, expansion in the volume of outstanding CDs appears to have moderated. But let me add that if further steps are needed to discourage banks from financing excessive expansion of business loans with CD funds, the Board could raise once again the reserve requirement on these deposits.

The Board, acting in concert with the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board, has also taken steps to protect the time and savings accounts of depository institutions, which are the preponderant source of mortgage funds for homebuilding. In recent months, as market rates of interest have become increasingly attractive to depositors, the inflow of savings funds to banks and other thrift institutions has dropped substantially. By lifting the ceiling on interest rates payable on time and savings accounts, the regulatory agencies have reduced the danger of severe stringency in the mortgage market.

Let me now turn briefly to the questions that are undoubtedly uppermost in the minds of the members of this Committee. What are the prospects for cooling off the economy? What are the prospects for reducing the rate of inflation? What are the prospects of an early end to direct controls on prices and wages? What are the prospects for regaining stability in foreign exchange markets? These are interrelated and difficult questions; and while neither I nor my colleagues on the Board have the gift of prophecy, we do have the duty of advising the Congress to the best of our ability.

There are, we believe, some convincing signs that economic expansion is slowing to a more sustainable pace. To give one example, industrial production increased at an annual rate of around 9-1/2 per cent during the first three months of this year. From March to June, the increase receded to an annual rate of about 6 per cent.

In part, this slowdown has reflected the impact of capacity constraints on the physical volume of production. But we also know that the advance of retail sales moderated and that an actual decline occurred in new housing starts during the quarter. All this may portend a more orderly growth of consumer expenditures, and therefore a lower rate of expansion in aggregate demand, over the remainder of 1973. However, the momentum of rising business expenditures for fixed capital and inventories, together with surging demands for our exports, seem likely to sustain a good rate of growth in industrial activity for some months yet.

It is against this backdrop of economic conditions that the prospects for price developments during Phase IV and beyond must be considered.

The President's decision to terminate the freeze on prices that went into effect about mid-June came none too soon.

Seriously adverse effects on agricultural supplies had begun to develop, because in some cases domestic prices were frozen at levels below production costs or below prices in foreign markets. Food prices, therefore, moved up sharply as soon as the freeze was lifted.

Food prices will probably continue to rise until the supply of agricultural products increases appreciably once again. Evidence on that score is discernible, but as yet inconclusive. The mid-year crop report by the Department of Agriculture suggests larger harvests of wheat, soybeans, and corn in the United States. Our acreage restrictions on agricultural production, moreover, have now been largely eliminated. Also encouraging is the fact that more attention is being given to production of soybeans in the developing nations -- notably in Brazil, Mexico, and Argentina. These are favorable trends for the longer term. In the near term, however, we must be prepared for a continuation of upward pressures on food prices.

The same is true of many industrial products. The controls imposed on prices of nonfood commodities under Phase IV are stringent. Costs can be passed through only

on a dollar-for-dollar basis, and many nonfood commodity prices will be effectively frozen until about mid-September because of the 30-day prenotification period. We cannot, however, realistically expect results in Phase IV comparable to those of Phase II. Economic conditions are very different now than in the summer and fall of 1971. At that time, we had substantial slack in labor markets, and a significant part of our industrial capacity was idle. Market forces therefore worked hand in hand with the control program in holding down wage and price increases. At that time, also, a more or less uniform rate of inflation had been underway throughout the economy for some time. The control program, consequently, did not need to allow many significant price increases in order to prevent disruptions in production or severe inequities.

Under present conditions, the repressing effects of the control program on prices will not have the support of market forces. Wage rate increases are creeping up; goods in many markets are in short supply relative to demand; foreign orders are there to take up slack that might be created by faltering domestic demand; import prices are still increasing

as a result of the devaluation of the dollar. Relative prices, moreover, are badly out of equilibrium. Producers have experienced sharp increases in costs of materials and supplies over the past six to nine months, and many of these cost increases have not yet been passed through to end products. In the present environment, the controls on prices and wage rates must therefore be administered with flexibility and practical wisdom if adverse effects on production and employment are to be avoided.

We have been operating under a system of direct controls over wages and prices for nearly two years now, and we can no longer count on benefits to the economy such as were experienced in Phases I and II. In view of existing circumstances, markets should soon be allowed to function more freely, so that they can perform their accustomed role in promoting economic efficiency, in encouraging investment, and in allocating resources to areas of greatest demand.

There is a continuing role for income policies in a modern economy. We need to move, however, toward the elimination of mandatory controls in areas where competition is reasonably effective in regulating prices and allocating resources. Over the long run, we will probably need to have thorough surveillance over wage rates and prices in key industries where competition is inadequate, but the large majority of wage and price decisions are best left to market forces. Our economy has grown and prospered under free enterprise in the past. We should not overlook this teaching of our history or its confirmation in other nations.

If this judgment is accepted, greater reliance in dealing with inflation -- both in the near future and over the longer term -- will have to be placed on fiscal and monetary policies. A further rise of prices in the months ahead is unavoidable. But the resulting damage can be minimized if excess demand is avoided. The inflationary forces that now plague us will then have a better chance to burn themselves out.

The Federal Reserve is prepared to coopèrate fully in this endeavor. It cannot, however, do the job alone. Additional fiscal restraint is also needed at this time. I for one would support stronger efforts to cut governmental expenditures or

actions to increase taxes. Particularly appropriate, in my view, would be fiscal measures -- such as a variable investment tax credit or a compulsory savings plan -- that could be quickly reversed, under special legislative rules, if economic activity began to weaken, as sometimes happens after a prolonged period of economic expansion.

Evidence of a larger sense of fiscal responsibility in the United States would help greatly in restoring the confidence in the dollar that is so badly needed to stabilize foreign exchange markets. By May of this year, the average dollar price of 10 major currencies (those of Japan, Canada, and 8 European nations) had risen some 20 per cent above the exchange parities that prevailed in the spring of 1970. This degree of realignment was generally regarded by financial authorities as necessary and helpful. But in the past 2 to 3 months, our nation's currency has suffered further depreciation, with the average dollar price of the above 10 currencies up 7 per cent, as the dollar price of the mark rose 20 per cent, the French franc 10 per cent, and the Swiss franc 12 per cent.

This latest depreciation in the value of the dollar cannot be justified on any realistic evaluation of international price levels, or underlying trends in our economy, or our balance

of trade or payments. In 1972, we experienced a trade deficit of nearly $7 billion -- a condition that had to be corrected and is being corrected. By the first quarter of this year the deficit shrank to an annual rate of less than $4 billion, and in the second quarter the deficit practically vanished. Exports will probably rise substantially further over the remainder of this year and in 1974, as the effects of our strengthened competitive position cumulate. The improvement in our trade balance is therefore likely to gather momentum, so that by 1974 and 1975 we should be experiencing a sizable trade surplus for the first time since the mid-1960's.

The recent excessive depreciation of the dollar in relation to Continental European currencies occurred despite this favorable outlook for the balance of trade and payments. Its causes cannot be identified with any precision. My own impression is that confidence waned with growing fears that inflation in the United States may have gotten out of hand. Other factors undoubtedly played their role -- among them, the tightening of monetary policies abroad, especially in West Germany, the sharp speculative run-up in the market price of gold, the spread of some uncertainty abroad about the ability of our government to handle economic problems effectively, and wild rumors about another devaluation of the dollar.

The unsettled behavior of exchange markets since mid-May has been a cause of serious concern to the monetary authorities here and abroad. This concern heightened in early July, when market conditions for a time became disorderly, and normal commercial transactions were adversely affected.

In these circumstances, and after full consultation with the Treasury and representatives of other countries, the Federal Reserve began to intervene in the exchange market. As reported on July 18, in a statement issued jointly by the Board and the Treasury, intervention will take place in the future at whatever times and in whatever amounts are appropriate for maintaining orderly market conditions.

A little over a month ago, I testified before your Subcommittee on International Economics that I had misgivings about a general system of floating exchange rates. The experience of recent weeks has strongly reinforced my skepticism. While we should not return to a system of exchange rates as inflexible as the one that evolved under the Bretton Woods arrangements, we also cannot afford a system that is subject to the kind of destabilizing speculation we have seen recently.

A major objective of current negotiations on monetary and trading relationships is to design and adopt an exchange-rate regime that avoids these extremes. But success in arriving at monetary arrangements under which international commerce and investment can flourish will elude us unless steps are taken, both here and abroad, to bring an end to the nearly chaotic inflationary conditions that now prevail throughout much of the world.

The domestic and international tasks that lie ahead of us are difficult but they are manageable. They must be seen in perspective. Our nation is experiencing great prosperity; but it is a marred and joyless prosperity, and so it will remain until we bring inflation under good control. We cannot do so until we put our financial house in order. A massive step in this direction would be taken if the Congress adopted this year proposals for budgetary reform such as were recently put forward by the Joint Study Committee on Budget Control. Its unanimous report favoring early enactment each year of a ceiling on expenditures, which would be organically related to the state of Federal revenues and the condition of the economy, deserves the enthusiastic support of this enlightened Committee.

****