Statement by

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before the

Subcommittee on Production and Stabilization

of the

Committee on Banking, Housing and Urban Affairs

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I am pleased to meet with this Committee to discuss the desirability of extending the Economic Stabilization Act.

Your immediate concern is whether to extend the existing authority under the Act, to modify that authority, or to abolish it altogether. The major question at issue is whether we would be better served as a nation by continuing to operate with mandatory wage and price controls, or whether the time has come to return to our historic tradition of reliance on free markets.

A considered judgment on this question requires careful analysis of our recent experience with governmental intervention in wages and prices. Let me begin, therefore, by assessing the benefits and costs of the control program over the past two and a half years.

The control program was instituted at a time when economic conditions were very different from what they are today. During the summer of 1971, we had a sluggish economy, unemployment averaged 6 per cent of the labor force, and a significant part of our industrial plant was idle. Nevertheless, unlike earlier periods of economic slack, the general price level continued to advance briskly. In fact, the average rate of price increase was about as high in the first half of 1971 as it had been in 1969, when both labor and capital were fully employed.
The inflationary problem in 1970 and 1971 stemmed mainly from the pressure of rising costs on prices. In general, wage rates were increasing much faster than gains in productivity. Business firms found it difficult to absorb the resulting rise in unit labor costs, since their profit margins were already seriously depressed. Prices therefore rose, even though excess demand for goods and services had long since been eliminated.

To some extent, the inflation we then experienced was the aftermath of previous excess demand. But as time passed, it became increasingly clear that the laws of economics were not working as they once had. In a modern economy -- and in other countries as well as our own -- wage rates have become fairly insensitive to changes in the balance between labor demand and supply, and increased costs of doing business are frequently passed through to buyers even in slack markets.

The New Economic Policy inaugurated in August 1971 sought to break a chain of wage-price increases that bore little relation to existing economic conditions. It also included measures to stimulate productivity gains, to increase business capital investment, to halt the deterioration in our balance of payments, and to encourage other nations to work with us in designing a more flexible system of foreign exchange rates.
The early response to the new policy was heartening. Consumers and businesses began to spend more freely, and the pace of economic expansion quickened. Meanwhile, governmental efforts to hold down wage and price increases met with some success. Broad measures of price performance registered significant improvement in the early stages of the control program, and there was little evidence that the controls were distorting business decisions or giving rise to serious inequities.

In the closing months of 1971 and most of 1972, the control program worked reasonably well because the volume of unemployed labor and capital, while diminishing, was still on the high side. Increases of wage rates during 1972 were somewhat smaller than in 1971. And although consumer outlays strengthened materially in 1972, the consumer price index rose only 3-1/4 per cent, or a full percentage point below the preceding year.

Over the course of 1972, however, the economic climate began to change in ways that threatened to undercut the control program. The growth of over-all production spurted to a rate well above its long-run potential, and demands for labor,
materials, and equipment strengthened steadily. Business firms began to experience some difficulty in adjusting production schedules to the rapid growth in consumer demand, and delivery delays became more frequent—even though capacity constraints were not yet limiting aggregate output. Towards the end of the year, the pace of economic expansion also accelerated in Western Europe and Japan, and prices of industrial raw materials began to rise faster both here and abroad. As these tensions accumulated during 1972, it became evident that the controls were causing some distortion in the allocation of resources, that inequities were becoming more numerous, and that pressures for modification of the program were mounting.

Let me now turn to 1973, when fresh inflationary forces, reinforcing those already plaguing the economy, culminated in the sharpest upsurge of the price level since the Korean War. In view of the strong cyclical expansion in production and employment that occurred in late 1972 and early 1973, it would have been difficult to avoid additional upward pressure on prices under the best of circumstances. In retrospect, it might be argued that monetary and fiscal policies should have been
somewhat less expansive during 1972, but it is my considered judgment that possible excesses of this sort were swamped by powerful special factors that added a new dimension to our inflationary problem last year.

Early in 1973, the move to Phase III made it easier to pass on rising costs to product prices and, here and there, to widen profit margins that had previously been suppressed. Also, since the inauguration of Phase III was widely interpreted as a virtual abandonment of controls, inflationary expectations tended to worsen. Looking back, however, it seems fair to conclude that the forces of inflation became so powerful during 1973 that they could not be dealt with very effectively by direct controls.

A major source of the inflationary problem last year was the coincidence of booming economic activity in the United States and in other countries. Production rose rapidly throughout the industrial world, and inflation accelerated everywhere. Among major industrial countries, increases in consumer prices in 1973 ranged from about 7 to 17 per cent. The United States was toward the low end of this range.

Another complicating factor was the devaluation of the dollar. The value of the dollar declined sharply in foreign exchange markets during the first half of last year, thereby
magnifying the impact of world-wide inflation on our price level. The higher prices of foreign currencies raised, of course, the dollar prices of imported products, and these effects spread out over the economy. Rising import prices led to some substitution of domestic for foreign products and thus intensified upward pressures on the price level. And as the dollar became cheaper for foreign buyers, our export trade expanded, thereby reinforcing the pressures of domestic demand on existing resources.

Last year, exports were also stimulated by the world-wide expansion of industrial output. Our country has long been a major supplier of industrial materials, component parts, and capital equipment. Larger foreign orders for these items added powerfully to growing domestic requirements. For example, foreign orders for durable goods (excluding motor vehicles and parts) shot up 25 per cent in the year ending in the fourth quarter of 1973, while domestic orders during the same period rose by 17 per cent.

The resulting demand pressures became particularly intense in the major materials-producing industries. Last
year, the rate of capacity utilization in these industries -- which include petroleum refining, aluminum, steel, cement, synthetic fibers, paper, paperboard, and the like -- reached the extraordinary level of 96 per cent in the third quarter, or about as high as this index of activity could go. In many of these industries, expansion of productive capacity had been neglected in recent years, in large part because of the low rates of profitability from 1966 to 1971 and the restrictions imposed by a variety of environmental controls. Since our industrial plant was incapable last year of accommodating the upsurge in demand, acute shortages developed for a wide range of basic materials.

To make matters worse, disappointing harvests in 1972 -- both here and abroad -- caused a sharp run-up in prices of food products during the first eight or nine months of 1973, and the disruptive manipulation since last fall of petroleum shipments and prices by some oil-exporting countries has caused a spectacular advance in the prices of gasoline and heating oil. Shortages of these two categories of products, in fact, account for a major share of our recent inflationary problem. About 60 per cent of the rise in the consumer price index in 1973
stemmed from increased prices of food and fuel; these same commodities, together with farm products, accounted for about 70 per cent of the rise in wholesale prices last year.

In short, the character of the inflation in 1973 was very different from the inflation that troubled us in earlier years. A world-wide boom was in process; the dollar was again devalued; agricultural products, basic industrial materials, and oil were all in short supply, and price increases of these products were enormous.

When an economy is beset by inflationary forces of such exceptional character, governmental intervention in pricing decisions or wage bargaining can hardly be expected to be very effective. Actually, governmental efforts to maintain a meaningful control program in the economic environment of 1973 aggravated the growing scarcity of a host of goods in our markets. In some instances, price controls have led to curtailment of less profitable lines of production. For example, roof bolts needed to increase output in the mining industry became virtually unavailable for a time. In other instances, critically needed materials have been exported because domestic prices were kept by governmental fiat
below the price level ruling in international markets. This was a problem in the market for copper scrap, for example, before price controls on this material were lifted in August of last year.

Moreover, in individual markets subject to excess demand, the controls have apparently encouraged devices for evading price ceilings. There have been various reports of "tie-in" sales, of old products being sold as new lines, and -- since imported goods are free from price controls -- of domestic goods being exported and then reimported and sold at higher prices.

Thus, the controls accentuated during the past year the vexing problem of scarcities that developed in many lines of production and distribution. The Cost of Living Council was well aware of this problem, and therefore moved towards a gradual relaxation or removal of the controls. But the damage done by the controls in slowing production was significant, and it is very doubtful if the control program helped to moderate the average rate of inflation during 1973.

The Committee on Interest and Dividends, which I have been chairing, also encountered difficulties in discharging its responsibilities. Early in 1973, the CID encouraged commercial
banks to hold down their prime rate of interest -- that is, the rate charged their large and most creditworthy business customers. Increasing costs of short-term borrowing in the money market, however, soon made the prime rate a bargain rate of interest. Since outstanding loan commitments by banks were large, and the total financing requirements of business were growing, commercial banks found themselves deluged with demands for loan accommodation. Action was clearly needed to avert a drying up of bank funds for small businesses, consumers, and home buyers.

Adoption by the Committee on Interest and Dividends of criteria for a two-tier prime rate structure alleviated the problem. A flexible prime rate, one closely tied to the highly competitive open-market interest rates, was permitted for large business borrowers who had access to the national money and capital markets. At the same time, a more stable rate, tied closely to actual costs, was to be maintained by the banks for borrowers with few financing alternatives -- notably, small businesses, consumers, and farmers.

This experience and others we have had with direct controls over the past 2-1/2 years have made it abundantly clear that there is no good substitute for free markets in allocating resources and in maintaining productive efficiency.
The experience of other countries has been similar to ours. Direct controls over wages and prices can be a constructive influence for a short time, particularly when there is significant slack in the economy. Such was the case in late 1971 and through much of 1972. But controls cannot restrain the upward movement of prices very long when aggregate demand is rising briskly and acute shortages develop in major sectors of the economy. Under such conditions, a rigorous control program gives rise to evasions and inequities, to inefficiencies, and to more acute and widespread scarcities. And in some markets, such as those for raw materials, agricultural products, or internationally traded commodities, direct controls over prices are -- practically speaking -- unworkable.

Let me turn now to the outlook for prices in 1974 and the role that controls might play in dealing with inflationary pressures in the months ahead.

The most pressing economic problem facing the nation at the present time is a shortage of petroleum products that is adversely affecting business activity and aggravating our price problem. Hardships for some of our people and inconveniences for many have become unavoidable.
Some downward adjustment of production and employment is already underway. Sizable cutbacks in production and layoffs of workers have recently taken place, or have been announced, in the automobile industry, the airlines, home-building, and other industries. For many countries, the adjustments will be more severe than for us.

Fortunately, the magnitude of the shortfall in our oil imports now seems likely to be smaller than it had originally appeared. However, the sharply higher price of imported oil will impose a burden which we cannot immediately escape. Prices of gasoline and heating fuels have already risen substantially, and -- even if price controls are continued -- may need to rise further in order to bring demand and supply into better balance. It is, of course, of the utmost importance that we permit markets to function in ways that will result in economies in the use of energy by business firms and consumers, and at the same time encourage a burst of new investment in facilities for exploring and producing crude oil and other sources of energy.

Food prices are also likely to rise this year. Stocks of major grains are low, and prospects for world crop
production in 1974 have been dimmed by shortages of fertilizer. Furthermore, meat supplies may be disappointingly small in the first half of the year. Although the outlook for food prices is by no means as gloomy as it was a year ago, there is no assurance that food prices will level out or decline very soon.

A more fundamental factor affecting the course of inflation in 1974, however, may well be the course of wage rates and unit labor costs. Increases in wage rates have been edging up since last spring; wages rose on the average at an annual rate of about 7-1/2 per cent during the last half of 1973. Even so, real weekly earnings of production workers have declined over the past year because prices have risen so sharply.

This year, the collective bargaining calendar is heavy and includes several pattern-setting industries. Efforts of workers to obtain large wage increases in order to prevent a further erosion of real income would be entirely understandable. If economic activity proceeds sluggishly in 1974, as now seems likely, productivity gains will probably be even smaller than they were last year. Substantial wage increases would therefore
put great upward pressure on costs of production and ultimately on prices.

The several adverse influences on the price level in 1974 are likely to be offset, in part, by other developments. A slower pace of economic activity here and abroad may well cause a decline in the prices of internationally traded commodities, besides reducing shortages of industrial materials and component parts. Appreciation of the dollar in international exchange markets over recent months will have a beneficial effect on the domestic price level. Imported goods will tend to be less expensive, and the demand for our exports will be moderated, thereby increasing the supply of goods available for the domestic market. Late in the year, pressures on food prices may also ease somewhat, as policies already adopted to increase agricultural production begin to bear fruit.

Realistically, however, we can hardly expect a return to reasonable price stability in the near future. Substantial increases in the prices of numerous commodities and services are virtually inevitable this year. Relative prices of many items are now badly out of balance. Prices of materials, for example, have recently risen very swiftly, and
these cost increases are still to be passed through to the prices of end products. Efforts to prevent such price adjustments would only prolong the distortions in production from which we are now suffering. And any determined attempt to force other prices down, with a view to achieving average price stability in the near future, would lead to intolerably high unemployment.

The objective of public policy in these difficult circumstances must be to establish a dependable framework for a gradual return to price stability over the next few years. In this endeavor, we will need to rely principally on sound management of aggregate demand through general monetary and fiscal policies.

In the current economic slowdown, the task of monetary policy will not be the same as in a classical business recession, when a considerable easing in the supply of money and credit can be expected to provide the financial basis for the subsequent recovery. This year, our nation's capacity to produce may actually decline, or at best rise at an abnormally low rate; declines in production and employment will tend to be concentrated in specific industries and regions of the country, rather than
spread broadly over the economy; and the price level is likely
to be rising at a disconcerting rate. Such developments are
outside the pattern of a typical business recession, and a great
deal of caution will therefore be needed in framing monetary
policy. An easier monetary policy can be only a marginally
constructive influence in an energy-induced slowdown. Rapid
growth of money and credit is hardly an effective remedy for a
shortage of oil.

Fiscal policy can be used to better advantage in this
kind of economic slowdown. Selective fiscal actions -- such as
an expanded program of public service employment, or increased
unemployment benefits for those who lose their jobs because of
the energy problem, or other special assistance in areas
particularly hard hit -- can be used more effectively to deal
with local or regional problems. And we should be able to
accomplish those objectives, I believe, without sacrificing
the longer-run fiscal discipline that is so vital to the restoration
of general price stability.

In the current economic environment, direct controls
cannot be of much benefit in curbing inflation. In fact, compre-
hensive and relatively inflexible controls over wages and prices
would probably do more harm than good, because they would
prolong the distortions in production and distribution that have become a major problem during the past year. I believe, therefore, that it would be unwise to extend the authority under the Economic Stabilization Act for another year. A more selective approach is needed.

For the remainder of 1974, continuation of mandatory controls over petroleum products appears unavoidable. The present shortages, particularly of gasoline, would result in skyrocketing prices if mandatory controls were not retained for a time. The control authority needed in this area is provided by the recently enacted Emergency Petroleum Allocation Act, which does not expire until early 1975.

Continuation of mandatory controls for health services may also be appropriate. This sector of the economy has demonstrated a high propensity towards inflation in recent years, in large part because the character of the industry makes it difficult for competitive forces to work effectively. A special program by the Department of Health, Education, and Welfare to moderate the rise in the cost of drugs, hospital care, and other medical services would help to keep spending on health care within the reach of our citizens, and it would also hold down the growth of Federal expenditures for national health programs.
In the construction industry, the mandatory authority available to the Construction Industry Stabilization Committee has thus far remained virtually unused. That Committee, relying on voluntary agreements between labor and management, has succeeded in reducing very substantially the rate of increase in construction wages since the spring of 1971. A continuation of mandatory control powers for the construction industry is perhaps unnecessary, but I would hesitate to disturb arrangements that have been so successful.

Except for these specific cases, I believe that the time has come to scrap the present structure of mandatory controls. The great mass of wages and prices should again be left to private decisions in free markets. In some markets, however, a degree of governmental vigilance may well be required to prevent abuses of economic power.

Mandatory controls are not the answer. On the other hand, a limited element of intervention in pace-setting industries may result in appreciable improvements of wage and price performance. Authority would be needed to delay wage and price changes, so that mediation or public hearings could be held and recommendations handed down. These recommendations
could then be monitored and reports issued on compliance, so that the force of public opinion could be brought to bear on wage or price changes that are deemed detrimental to the national interest. Functions of this kind could best be handled by ad hoc boards for specific cases, to be established by the Cost of Living Council or some successor agency.

Installation of the necessary review machinery may take some time, however. Partly for this reason, partly also because significant elements of the economy may still be under control by April 30, extension of the Economic Stabilization Act for 2 or 3 months might be desirable to allow time for an orderly transition to substantially free markets.

I believe that a determined national effort to curb inflation also requires greater stress on programs for reducing obstacles to supply, and for encouraging investment in industries where capacity constraints are limiting the expansion of our national economy. Events of this past year have focused attention on the urgent need to increase supplies of energy, and also to expand the productive capacity of our basic materials industries. Accelerated amortization of capital facilities for such industries, using techniques developed during the Korean War, could help
solve this problem by making adequate tax allowance for the high cost of pollution control equipment and for the risks attending stepped-up investment in these vital industries.

Efforts to enlarge our supply potential, however, should go beyond the provision of investment incentives in the basic materials industries. For example, vestiges of our former restrictive agricultural policies could be removed, and the minimum wage law could be modified to increase job opportunities for teenagers. Furthermore, a wide range of restrictive practices in the private sector -- from featherbedding to outdated building codes -- cry out for reform.

Efforts to remove impediments to supply and improve productivity are more likely to be successful if we establish machinery to focus on this problem over the long run. I would suggest, therefore, that the Council of Economic Advisers be given the responsibility of developing specific programs, of making semi-annual reports on the progress being achieved, and of recommending policies needed to further the broad objective of expanding our capacity to produce.

In summary, my suggestions to this Committee are as follows: First, that our nation again permit wages and prices
to be set preponderantly in free markets, and that we depend principally upon monetary and fiscal policies to establish an economic environment conducive to a return of general price stability; second, that mandatory control programs be confined to petroleum products, health services, and the construction industry; third, that the present Economic Stabilization Act be extended, if at all, for only two or three months beyond April 30th; fourth, that the Cost of Living Council or a successor agency assume responsibility for establishing ad hoc boards that would seek through public hearings, or in other ways short of compulsion, to prevent abuses of economic power over wages and prices in pace-setting industries; fifth, that our nation embark on a long-range effort to reduce obstacles to the expansion of supply, and that the Council of Economic Advisers be required to recommend programs needed to further this objective, and to make semi-annual reports on progress achieved.

I believe that implementation of these suggestions will contribute to a slowing in the rate of inflation over the course of 1974. In any event, I hope that the Congress will look at all sides of the inflation problem, and consider thoroughly these and other suggestions that may come to its attention.
This nation has been struggling with inflation for almost 
a decade. Our citizens are well aware of its seriousness, and 
they are realistic enough to realize that there is no easy way 
to regain price stability. But I am deeply concerned that the 
patience of our people is wearing thin. Failure to make 
significant headway this year in reducing the rate of increase 
in prices may destroy the confidence of businessmen and 
consumers in the capacity of our government to deal with an 
inflationary problem that is retarding economic progress 
and sapping the energies of our people. Improvement in the 
price performance of our economy during 1974 is essential to 
our country's future and is well within our means.

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