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Statement by

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before the

Joint Economic Committee

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

Economic life never stands still. During 1973, taken as a whole, the real output of our economy moved to a higher level, unemployment fell, domestic sales rose, exports soared, and business profits improved. But the year was also characterized by sharp contrasts in the movements of production, income flows, prices, and practically every economic factor. Financial markets experienced great turbulence, and both the nation's mood and its economic activities suffered as the forces of inflation gathered momentum.

Early in 1973, our economy was in the midst of a boom of exceptional intensity. Business expenditures for new plant and equipment were accelerating, home-building activity was at a record level, consumer spending was moving up briskly, and exports were climbing in response to exuberant activity abroad and an improved competitive position of American goods in foreign markets. With the demand for goods and services increasing so strongly, growth in total real output during the first quarter rose

to an annual rate of almost 9 per cent. Production of our nation's factories and mines increased even faster.

But as inevitably happens in the course of a vigorous cyclical upswing, constraints on supply soon began to be felt. Shortages of raw materials and component parts became widespread in the second half of the year, when the rate of utilization of the productive capacity in the major materials-producing industries reached 96 per cent. And as the unemployment rate for adult males kept falling, it became harder and harder to find skilled workers.

Special problems in some markets contributed to the slowing pace of economic expansion. The volume of residential construction was adversely affected by stringency in the mortgage market--a subject to which I will return. Also, retail sales became rather sluggish after the first quarter, in part because consumers had recently stocked up on automobiles and other consumer durables and were somewhat reluctant to increase their instalment debts further. But the basic reason for the weakening of retail trade was erosion of the buying power of American families.

During 1973, average weekly earnings of workers in the private nonfarm economy rose about 7 per cent, which is a large increase by historical standards. The level of consumer prices, however, rose even faster. With social security and other taxes also increasing, the real weekly take-home pay of the average worker was about 3 per cent lower at the end of 1973 than a year earlier. Inflation reduced also the real value of savings. Even if we take no account of the decline in the prices of common stocks, the dollar value of the other financial assets held by individuals rose less than consumer prices during 1973; in other words, the real value of these accumulated savings actually declined during the year.

Many consumers responded to the decline of their real income and savings by postponing or cancelling plans for buying big-ticket items. Sales of new autos began to slip in the spring, and so too did purchases of furniture and appliances. Factory shipments of mobile homes reached a peak in the first quarter, then declined by almost one-third by year-end. And the drop in sales of new conventional houses was not only a response to stringency in the mortgage market; it reflected also the declining

real income of the average American worker and the sharply higher prices of new homes.

Inflation thus seriously retarded economic progress last year, as it has often done on prior occasions. Let me turn, therefore, to the reasons why our inflationary problem worsened in 1973.

In view of the strong cyclical expansion in economic activity that developed in late 1972 and early 1973, it would have been difficult to avoid some 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. It is the Board's judgment, however, that any upward pressures on prices arising from this source were overtaken and swamped by powerful special factors that added a new dimension to our inflationary problem.

A major source of the rapid inflation during 1973 was the coincidence of booming economic activity in the United States and in other countries. Production rose rapidly throughout the industrial world; prices of labor, materials, and end products were bid up; and inflation accelerated everywhere.

Another complicating factor was the depreciation of the dollar in foreign exchange markets during the first half of last year. The dollar's decline magnified the impact of world-wide inflation on our price level. Higher prices of foreign currencies raised the dollar prices of imported products, and these effects spread through the economy. And as the dollar became cheaper for foreign buyers, our export trade expanded, thereby reinforcing pressures of domestic demand on our resources.

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. Sharply higher foreign orders for these items added powerfully to growing domestic requirements.

The resulting demand pressures became particularly intense in the major materials-producing industries--that is, industries producing aluminum, steel, cement, synthetic fibers, paper, paperboard, and the like. In some of these industries, productive capacity had grown little in recent years -- a result of the low rates of profitability from 1966 to 1971 and, to some degree also, of the restrictions imposed by environmental

controls. Since our industrial plant was incapable of accommodating the upsurge in demand last year, acute shortages developed for a wide range of basic materials.

To make matters worse, disappointing harvests in 1972 -- both here and abroad -- forced a sharp run-up in food prices during the first eight or nine months of 1973. Later, the disruptive manipulation of petroleum shipments and prices by major oil-exporting countries caused a spectacular advance in the prices of gasoline and heating oil. Rapidly rising prices of food and fuel, in fact, have accounted for a large part of our recent inflationary problem.

These sources of inflation are still with us. In January, there was a large further rise in wholesale prices of fuels and of farm and food products. Widespread increases occurred also among industrial commodities. And consumer prices moved up at an annual rate of nearly 13 per cent, with about three-fourths of the increase accounted for by food and energy items.

In short, the character of the recent inflation has been very different from the advances in the general price level that troubled us in earlier business-cycle expansions. Last year, a

world-wide boom was in process; the dollar was again devalued; agricultural products, basic industrial materials and oil were in short supply, and price increases of these products were enormous.

When an economy is beset by inflationary forces of such exceptional character, direct controls over wages and prices are apt to be rather ineffective. The classical tools of economic stabilization -- that is, general monetary and fiscal policies -- can be more helpful at such a time, but limitations on their practical use in the environment of 1973 must also be recognized. When prices of numerous commodities are being moved up by powerful special factors, a strongly restrictive monetary and fiscal policy, aiming to achieve average price stability in a short time frame, would drive other prices sharply down and soon lead to intolerably high unemployment.

The Federal Reserve has sought to shape monetary policy in these troubled times with a sensitive eye to changing economic and financial forces. In view of the inflationary tendencies already evident in the spring of 1972, the mounting pressures in financial markets were allowed to express

themselves in higher short-term interest rates. Later that year, as evidence emerged of world-wide inflationary problems, the Federal Reserve moved further toward monetary restraint. Open market operations were conducted so as to exert pressure on the reserves of commercial banks, and margin requirements on common stocks were raised.

By early 1973, expansion of the money stock and related bank credit began to slow. Private credit demands, however, remained exceptionally strong, with most of the increased demand concentrated in short-term markets. Commercial banks, in particular, were deluged with business loan demands. The consequence was a sharp rise in short-term market interest rates; long-term rates followed suit, although with a lag and to a much smaller degree.

The rise in money market rates, together with heavy customer loan demands, induced commercial banks to step up their borrowing at the discount window. The Board sought to discourage expansion of bank reserves through this source, and also to emphasize the restrictive thrust of monetary policy, by raising the discount rate in successive steps from 4-1/2 per cent at the beginning of 1973 to 7-1/2 per cent in August.

In addition, shortly before midyear, the Board increased the reserve requirements on demand deposits of member banks. Earlier, the reserve requirement applicable to increases in large-denomination time certificates of deposit had been raised from 5 to 8 per cent. Later on, this marginal reserve requirement was raised further -- to 11 per cent. These changes in reserve requirements reinforced the restrictive effects of open market operations and of discount policy, and thereby helped to moderate the expansion in money and bank credit.

Toward the end of last summer, it became apparent that Federal Reserve policies had brought the major monetary and banking aggregates under good control. For example, the narrowly-defined money supply grew at an annual rate of 5-1/2 per cent in the third quarter, compared to 7-1/4 per cent in the first half of the year and 7-3/4 per cent in 1972. Again, total loans and investments at all commercial banks grew at an annual rate of about 12 per cent in the third quarter, compared with 18 per cent in the first six months.

Evidence also began to accumulate after mid-1973 that the rate of expansion in over-all economic activity was tapering off. In late September, therefore, the Federal Reserve moved away very cautiously from its earlier policy of active restraint. Open market operations began to be conducted with a view to easing somewhat the availability of bank reserves, and this policy was cautiously extended when the oil shortage further clouded the economic outlook. In addition, the marginal reserve requirement on large-denomination certificates of deposit was reduced last December from 11 to 8 per cent, and this January the margin required on purchases of common stock was set at 50 instead of 65 per cent.

Looking back over the past year, we believe that the course of monetary policy was generally appropriate. Growth rates of monetary and credit aggregates were slowed, as they should have been in a period of intense inflationary pressures. And the response of monetary policy to the slowing pace of economic expansion last fall was timely but prudent, as we again think the circumstances required.

The financial developments that I have sketched had a serious impact on the residential mortgage market and the home-building industry. In view of the social importance of this industry, let us turn back and review the special problems that developed in the market for residential mortgages.

During the second quarter of 1973, as yields on short-term market securities became increasingly attractive, individuals began to channel more of their savings into market securities -- in some cases, withdrawing funds from time and savings accounts at depository institutions for this purpose. In consequence, new commitments for mortgages, particularly by savings banks and saving and loan associations, began to taper off. Reduced availability of mortgage credit thus reinforced the adverse effects on homebuilding that stemmed from rising interest rates, inflated construction costs, and declining real incomes of many workers.

In view of the extensive diversion of personal savings into market securities, it was clearly essential to enhance the ability of depository institutions to compete for savings funds. The Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board therefore moved jointly at mid-year to raise interest-rate ceilings on consumer-type time

and savings deposits, and to remove all interest-rate constraints on certificates of deposit with maturities of 4 years or longer.

At about the same time as this action was taken, the Board imposed a marginal reserve requirement on large-denomination certificates of deposit, as I noted earlier. This addition to the cost of funds raised by commercial banks was expected to discourage business loans, and thereby help to make more bank funds available for residential mortgages or other uses.

Most depository institutions moved quickly, but prudently, to take advantage of the greater opportunity that the new interest-rate regulations gave them to compete for the savings of individuals. Yields on short-term market securities, however, continued to climb during the summer, and savings flows to the depositories weakened further.

The weakness of time and savings deposits at nonbank thrift institutions during the summer months led the Congress to pass legislation in October requiring interest-rate

ceilings on all categories of consumer-type time and savings deposits. The effects of this legislation are uncertain, since the worst of the savings flow problem had passed by September. Many of the interest-sensitive depositors had by that time already shifted their funds into market securities, and market interest rates too had begun to decline.

The flow of savings to the thrift institutions strengthened over the remainder of 1973, and mortgage credit became more readily available. At present, mortgage interest rates are appreciably lower than they were last summer and fall. The homebuilding industry, however, continues to be depressed.

Last year's experience has demonstrated once again how vulnerable the mortgage market still is to changes in general credit conditions. The Board addressed this problem in a report to the Congress two years ago. We continue to believe that adoption of a flexible tax credit on business investment is the most important single step that could be taken to reduce the instability in mortgage finance and homebuilding.

Let me turn, finally, to the matters that are of chief concern to this Committee -- namely, the outlook for economic activity and prices, and the responsibilities for public policy that this Committee has under the Employment Act.

The nation faces at the present time a severe shortage of petroleum products that is slowing business activity and aggravating our inflationary problem. Shortages of other materials and supplies also remain acute. While these difficulties are limiting production in some firms, other enterprises -- as previously noted -- are experiencing weaker demand for their products. The oil shortage has had particularly adverse effects on the purchase of new autos, of homes in outlying suburban areas, of recreational vehicles and other travel-related goods and services. For some of these items, demand had begun to weaken even before the oil crisis.

A downward adjustment of production and employment is therefore underway. Industrial output declined in December and again in January, and unemployment last month rose rather sharply, to 5.2 per cent of the labor force. I would expect some further weakening of economic activity, with industrial production probably declining and unemployment rising in the months immediately ahead.

The current economic slowdown, however, does not appear to have the characteristics of a typical business recession. To date, declines in employment and production have been concentrated in specific industries and regions of the country, rather than spread broadly

over the economy. In some major sectors, the demand for goods and services is still rising. Capital spending plans of business firms remain strong, and so do inventory demands for the many materials and components in short supply. Meanwhile, prices are continuing to rise very rapidly.

Expenditures by businesses for fixed capital will probably continue to rise in view of the urgent need for added capacity in a number of our basic industries. Residential construction may pick up later in the year, in response to the improvement that has been occurring in mortgage credit supplies. With government expenditures at all levels also moving higher, it seems unlikely at present that the current economic slowdown will become pervasive or be of extended duration.

Our nation's business firms and consumers already have found ways to economize on their uses of oil and other forms of energy. For example, there have been significant declines during recent months in the use of fuel oil and electricity across the nation. As 1974 moves on, these adjustments may be expected to continue. Domestic output of crude oil will increase gradually;

electric utilities will shift to greater reliance on coal; auto manufacturers will expand their capacity to produce the smaller cars that are increasingly demanded by consumers; and myriad other adjustments will be made to the energy problem. In numerous ways we are, even now, laying the basis for recovery in business activity.

Improvement in the price performance of our economy during 1974 is well within our means. The rise in consumer prices should moderate later this year as petroleum prices decline or level off in response to the drastic adjustments now under way in oil markets around the world, and as our own food supplies expand in response to incentives for farmers to increase production. There are other favorable price developments on the horizon. A slower pace of economic activity, both here and abroad, may cause a decline in the prices of industrial raw materials and internationally traded commodities. Also, the net appreciation of the dollar over recent months in foreign exchange markets should restrain the prices of imported goods and moderate the demand for our exports, thereby increasing the supply of goods available in domestic markets.

Realistically, however, we can hardly expect a return to general price stability in the near future. Substantial increases in the prices of numerous commodities and services are practically unavoidable this year. Relative prices of many items are now badly out of balance. Prices of materials, for example, have recently risen very swiftly, and many of these cost increases are still to be passed through to the prices of end products.

A more fundamental factor affecting the course of inflation in 1974, however, may well be the course of wages and unit labor costs. Increases in wage rates have been edging up since last spring. If economic activity proceeds sluggishly this year, as now seems likely, productivity gains will probably be even smaller than they were last year. A rise of wages that is faster than we have recently experienced would therefore put great upward pressure on costs of production and ultimately on prices.

Whatever the cause, if rapid inflation continues this year, it may undermine confidence, send interest rates soaring, and wreck our chances of regaining a stable and broadly based prosperity in any near future. It may also destroy the gains we have recently made in strengthening our competitive position in world markets, and in improving our balance of payments. Let us not overlook

the fact that the sharp rise in prices that occurred this January has already served to reduce the dollar's strength in foreign exchange markets.

A great deal of uncertainty now surrounds the outlook for the balance of payments. One thing, however, is entirely clear -- our trade balance, and that of other oil-importing countries, will be affected very adversely by the price of imported oil. Fortunately, our competitive position in world markets is stronger than it was several years ago, and our exports may therefore increase at a good rate despite the slowdown that now appears to be under way in the economies of Europe and Japan. Even so, our merchandise trade balance will probably register a substantial deficit in 1974 because of the rising oil-import bill. Other nations that are more heavily dependent on imported oil than we are could well experience trade deficits of unprecedented magnitude.

Increases in the revenues of oil-exporting countries will therefore be huge. The bulk of these revenues will be invested, since only a small part can be spent productively for imports in the short run. Consequently, many industrial countries will experience large capital inflows in 1974.

Because of the size and efficiency of our capital markets, the United States is likely to receive -- directly or indirectly -- a substantial share of the capital flow from oil-exporting countries. But there may also be additional outflows of capital from the United States. Some nations will wish to finance their oil payments by borrowing in our financial markets. Also, private capital outflows may increase because of the recent relaxation, here and abroad, of controls on capital flows. In the end, the net flow of capital to this country might equal, or even exceed, the decline in our trade balance attributable to the larger dollar value of oil imports; but the way in which the balance of payments will unfold is highly uncertain, and this will require great vigilance on our part.

The problems for international financial markets created by the present price of oil are very serious. Short of some reversal of policy by the oil-exporting nations, there is no way to avoid them. Nor is there any way to avoid adjustments in our own economy to the more limited supplies and higher costs of petroleum products.

In short, public policy at the present time is confronted with an exceptionally difficult economic situation. Inflation is proceeding at a dangerous pace, unemployment is rising, strong inflationary forces are likely to continue in 1974, and international financial relations have become strained.

Our best chance of surmounting these difficulties is to face up squarely to the gravity of the inflation problem. Inflation cannot be halted this year. But we can and should move resolutely this year to establish a dependable framework for a gradual return to reasonable price stability. Direct controls over prices and wages will not be of much further benefit in this effort. Machinery for reviewing wages and prices in pace-setting industries can, however, prove helpful; and so too may a concerted effort to enlarge our capacity to produce industrial materials, enhance productivity, and further reduce prevailing restrictions on international trade. But, in the end, inflation will not be brought under control unless we have effective 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. As a consequence of the oil shortage, our capacity to produce may actually decline in 1974, or at best rise at an abnormally low rate. A highly expansive monetary policy would do little to stimulate production and employment; but it would run a serious risk of rocking financial markets, causing the dollar to depreciate in foreign exchange markets, and intensifying our already dangerous inflationary problem.

Fiscal policy can be used to better advantage than monetary policy in promoting prompt recovery in the present economic environment. Selective measures such as an expanded public employment program, increased unemployment benefits, or some liberalization of welfare payments in hard-hit areas, may be useful in cushioning the economic adjustments now under way. Also, a selective tax policy of accelerated amortization could stimulate investment in the energy and other basic materials industries, thereby relieving the more critical shortages of capacity that have recently proved so troublesome.

Current economic conditions may justify special fiscal measures of this kind. But the Board would strongly advise against adoption at this time of broadly stimulative fiscal measures, such as a general tax cut or substantially enlarged expenditures. It is not clear that a strong dose of fiscal stimulus is needed now, and we surely need to proceed cautiously at a time when the price level is still soaring.

This influential Committee can be tremendously helpful in getting our economy back to a sound track. Last month's advance of the consumer price index -- an increase at an annual rate of more than 10 per cent -- is a grim warning that we are on the brink of a two-digit inflation. It is of vital importance to the current state of confidence and the long future of our nation that we make significant progress in slowing the rate of inflation this year.

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