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Statement by

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before the

Joint Economic Committee

August 6, 1974

I am pleased to appear before this Committee once again to present the views of the Board of Governors on the condition of the national economy.

Our country is now struggling with a very serious problem of inflation. In the past twelve months, the consumer price level has risen by 11 per cent; wholesale prices have risen even faster. When prices rise with such speed, inflation comes to dominate nearly every aspect of economic life.

The current inflation is of world-wide scope and of virulent intensity. Among the principal industrial countries, consumer prices over the past year have risen anywhere from 7 to over 20 per cent, while wholesale prices have advanced from 15 to over 40 per cent. Inflation is also raging among the less developed countries, and apparently in socialist countries as well as in those practicing free enterprise.

A major cause of the stepped-up rate of inflation around the world was the coincidence of booming economic activity among major industrial nations during 1972 and 1973. With production rising rapidly, prices of labor, materials, and finished products were bid up everywhere. The pressures of demand were particularly acute for industrial materials; severe shortages developed and prices of these commodities skyrocketed.

The impact of world-wide inflation on our own price level was magnified by the decline since 1971 in the value of the dollar in foreign exchange markets. Higher prices of foreign currencies raised the dollar prices of imported goods, and these price increases were transmitted to domestic substitutes as well as to finished products based on imported materials. Moreover, as the dollar became cheaper for foreign buyers, our export trade increased rapidly and thus reinforced the pressure of demand on domestic resources.

Other special factors have also contributed to the higher rate of inflation since the beginning of last year. Disappointing harvests in 1972 -- both here and abroad -- forced a sharp run-up in food prices during 1973. And the manipulation of petroleum shipments and prices by oil-exporting countries has caused a spectacular advance since last fall in the prices of gasoline, heating oil, and other petroleum products.

More recently, the removal of direct controls over wages and prices has been followed by sharp upward adjustments in both labor and commodity markets.

The inflation that we have been experiencing has already caused injury to millions of people and its continuance threatens further and more serious damage to the national economy.

As a result of the inflation, consumer purchasing power is being eroded. During the past year, the take-home pay of the typical worker declined nearly 5 per cent in real terms.

As a result of the inflation, the real value of the savings deposits, pensions, and life insurance policies of the American public has diminished.

As a result of the inflation, financial markets are experiencing strains and stresses. Interest rates have moved skyward. Some financial and industrial firms have found it more difficult to roll over their commercial paper or to raise needed funds through other channels. Savings flows to thrift institutions have diminished, and stock prices have plummeted.

As a result of the inflation, profits reported by corporations have risen sharply; but much of the reported profit is illusory because it fails to take into account the need to replace inventories, plant, and equipment at appreciably higher prices.

In short, as a result of the inflation, much of the planning that American business firms and households customarily do has been upset and become confused. The state of confidence has deteriorated and the driving force of economic expansion has been blunted.

It should not be surprising, therefore, that the physical performance of the economy has remained sluggish in recent months, despite the lifting of the oil embargo that depressed the economy last winter. Auto sales have recovered somewhat since March, but total retail sales -- allowing for price advances -- have continued to move sidewise. Residential building activity is in a slump. Although the volume of new housing starts rose a little in June, the average for the second quarter fell and the number of new building permits also declined. Actually, most major sectors of the economy recorded little or no change of activity in the second quarter, and early estimates suggest a slight further reduction of the real gross national product in that three-month period.

Recent economic movements do not have, however, the characteristics of a cumulative decline in business activity. In a typical business recession, all -- or nearly all -- comprehensive indicators of economic activity move downward simultaneously. That is not the case presently. For example, the demand for labor has remained strong. Employment has continued to rise, and the unemployment rate appears to be at about the same level now as it was in January.

In the industrial sector, production has recovered somewhat over recent months; factory shipments have continued their upward course; and new orders received by manufacturers of capital goods have risen further. Unfilled orders on the books of business firms, especially in the capital goods industries, are enormous and are still advancing, as shortages of critical materials and parts continue to hold back production schedules.

In addition to the business capital sector, our export markets are a source of continuing strength to the economy. Also, some businesses are adding significantly to their inventories, in order to replenish depleted stocks and bring them into better balance with sales. These sources of strength have kept up activity in the industrial sector and have prevented the downward tendencies in our economy from cumulating in the manner characteristic of economic recessions.

We should, however, act decisively to bring inflation under control before these remaining sources of strength are undermined. If interest rates continue to soar, if construction costs and equipment prices continue to rise at a feverish pace, if our export prices continue to mount, we may eventually find that incentives for business investment are being eaten away and that our export markets are shrinking.

Let me turn now to the condition of international financial markets and recent trends in our international trade and payments accounts.

Our foreign trade balance has moved into deficit this year, principally because of the huge increase in the bill for imported oil. The dollar value of our fuel imports rose from an annual rate of $8 billion in the second quarter of 1973 to a $28 billion rate in the second quarter of this year. The deterioration in the overall trade account was much less than this, however, since our exports over the past year have risen much more than imports outside the petroleum category.

Partly for these reasons, partly also because our money and capital markets have been attracting funds from oil-exporting nations, the high price of imported oil has not created a serious balance of payments problem for the United States. Uncertainties surrounding the effects of recent oil prices have given rise to large and rather unsettling swings in the value of the dollar relative to other currencies since last October, but on balance the dollar is stronger now than it was at that time. The value of the dollar in exchange markets began to recover last October, fell once again between this February and May, and since then has gathered some strength. At present, the average price of the dollar in exchange markets, although below the high point reached in January, is still about 6 per cent higher than it was in October of last year, before the oil crisis. Intervention in exchange markets by the Federal Reserve and other central banks, while not extensive, has helped to prevent exchange rate fluctuations from becoming unduly large and upsetting to the calculations of firms operating in international markets.

Other oil-importing countries have fared less well during this difficult period of high and rising oil prices. For many of the less developed nations around the world, the rising costs of fuel and fertilizer have shattered plans for economic development. Industrialized nations also -- notably Italy and to a lesser extent other countries such as Japan -- have experienced severe strains in their international payments accounts. And all oil-importing countries have suffered a significant loss of consumer purchasing power due to the massive increase in fuel costs.

Unless the price of oil declines materially, the oil-importing nations as a group cannot avoid sizable deficits in their current international accounts. This situation is fraught with danger for the stability of international financial markets. It is by no means clear that private financial institutions will be able to recycle the huge surpluses of the oil-exporting nations to the many nations of the world that are experiencing current account deficits. A substantial decline in the price of oil is, in my judgment, essential and requires the closest attention of the world's statesmen.

Strains in the international financial system will, of course, be reduced if the oil-exporting nations use their surpluses to provide assistance to countries with current account deficits -- if not directly, then indirectly through international financial institutions. Tension in international financial markets will also be lessened if countries throughout the industrialized world, besides practicing conservation in the use of oil, assign high priority to gaining control over their internal inflationary problem. Most of them are now relying on monetary or fiscal restraints for that purpose, and the world-wide boom in economic activity is therefore abating. If we and other nations around the world persist in this struggle, the raging fires of inflation will eventually burn themselves out.

In our own country, the battle against inflation has relied heavily on monetary restraint. The Federal Reserve recognizes that a restrictive monetary policy is bound to cause some inconvenience and even hardships. While we have tried to apply the monetary brakes firmly enough to get results, we have also been mindful of the need to avoid a credit crunch.

Thus, the supply of money and credit has continued to grow. During the past twelve months, the narrowly-defined money stock -- that is, currency plus demand deposits -- has increased 5 1/2 per cent, while the loans and investments by commercial banks have risen by 12 per cent.

Since the beginning of this year, the annual rate of growth of these two magnitudes has been a little higher -- 6 1/4 per cent for the narrow money stock and 13 1/2 per cent for total bank loans and investments. For one category of credit -- namely, business loans of commercial banks -- the annual rate of growth has been much higher, in fact over 20 per cent during the first half of this year.

Clearly, the American economy is not being starved for funds. On the contrary, growth of money and credit is still proceeding at a faster rate than is consistent with general price stability over the longer term.

Yet, the demand for money and credit has been rising at a very much faster pace than the supply. This huge and growing demand for borrowed funds reflects the continuing strength of business capital investment; it reflects the efforts of many firms to rebuild inventories that were depleted by earlier shortages and slow deliveries; it reflects the inflated prices at which inventories must now be replenished; and it reflects, to some degree, anticipatory borrowing by those who fear that credit may later be unavailable or be still more costly.

In any event, with the demand for credit expanding much more rapidly than supply, credit markets have tightened, and interest rates have risen to levels such as we have not previously known in over a century of our nation's recorded experience.

For example, the rate of interest that commercial banks charge on short-term loans to their largest and best known business customers has risen to 12 per cent. In recent weeks, many of these same business firms have been paying from 11-1/2 to 12-1/4 per cent in the commercial paper market. Long-term interest rates have also risen substantially. The highest-grade corporate bonds are selling at yields around 10 per cent; rates on tax-exempt securities have been averaging about 6-1/2 per cent. Home buyers now face mortgage interest rates of 9 per cent or more.

These interest rate levels are disquieting. They cause difficulties for many individuals and pose a threat to the viability of some of our industries and financial institutions. But we cannot realistically expect a lasting decline in the level of interest rates until inflation is brought under control. When the rate of inflation is 11 or 12 per cent, an interest rate of even 10 per cent means that the rate of return to the lender, in real terms, is negative.

Evidence is accumulating that the restrictive policy pursued by the Federal Reserve is helping to moderate aggregate demand by reducing the availability of credit to potential borrowers and disciplining inflationary psychology. In the first half of last year, the credit extended to private domestic borrowers increased at an annual rate of $165 billion and amounted to about 14-1/2 per cent of the private component of the gross national product. Estimates for the first half of this year suggest that the rate of aggregate private credit expansion has fallen to about $145 billion, or 11 1/2 per cent of private GNP.

Of late, many businesses attempting to borrow at commercial banks have found it more difficult to obtain loans. The public securities markets have also been less receptive. Since the beginning of this June, cancellations or postponements of corporate bond and stock offerings have amounted to almost $2 billion. State and local governments have also been affected; cancellations or postponements of municipal security offerings since early June have amounted to about $800 million.

Some sectors of our economy now face unusually difficult problems. The housing industry -- which had already been suffering from the erosion of workers' purchasing power, from rising construction and land costs, from fears of a gasoline shortage, and from overbuilding in some areas -- is now experiencing added hardships because of soaring interest rates and reduced availability of mortgage credit at savings institutions and commercial banks. Public utilities have also been caught in a squeeze; the rates charged to their customers have lagged behind the prices of fuel and other materials, while rising interest rates have been adding to the costs of debt service.

During the recent boom, some carelessness crept into our financial system, as usually happens in a time of inflation. Some commercial banks permitted their liabilities to grow much faster than their capital. They also allowed dependence on volatile funds -- such as overnight loans from other banks, certificates of deposit, and Eurodollars -- to reduce their liquidity. The great majority of our banks have been managed prudently; but in some instances unhealthy practices have turned up -- such as speculating in foreign exchange or acquiring large amounts of long-dated securities.

Striving for quick profits is a characteristic feature of an inflationary boom. In fact, our entire business system has come to rely on credit too heavily, as so often happens in a time of exuberance. But financial adventuring on the part of banking firms -- whether in the United States or abroad -- is especially deplorable, since mistakes on the part of individual banks can have pervasive effects on the state of confidence.

Taken as a whole, however, the commercial banking system in the United States is entirely sound, and it can be counted on to continue to function efficiently. My judgment is based on the actual condition of our banks, and it reflects also the state of readiness of the Federal Reserve to deal with such temporary financial problems as may arise.

The Federal Reserve stands ready, as the nation's lender of last resort, to come promptly to the assistance of any solvent bank experiencing a serious liquidity problem. Besides, the Federal Reserve has long had on hand well-laid contingency plans for assisting, if the necessity should arise, other types of enterprises experiencing liquidity problems.

The need to activate these plans appears remote. But the resources of the Federal Reserve are enormous, and there should be no uncertainty about our readiness to deal with financial emergencies.

Tensions in financial markets have lessened in recent weeks, but they may continue to trouble us until more evidence appears that the rate of inflation shows promise of diminishing. There are a few hopeful signs that price increases may abate during the second half of this year, but they are inconclusive.

The role of the special factors that served to accelerate price increases during the past year or two is now waning. Food and fuel prices have recently contributed less to the rise in the consumer price level than they did in 1973 or early 1974. The boom in our own economy and that of other nations has tapered off, and the pressure of demand on available industrial capacity should therefore continue to diminish.

The underlying problem of inflation, however, remains very grave. The Federal budget continues to be in deficit. Farm prices, which had a downward trend during the past ten months, have again staged a spirited recovery in the past few weeks. Shortages of materials and component parts -- for example, steel, aluminum, coal, bearings, electric motors, forgings -- continue to be troublesome.

Most serious of all, the rise of wage rates has accelerated sharply this year, while industrial productivity has been stagnating. Hourly earnings in the private nonfarm economy rose at an average annual rate of 10 per cent during the second quarter, and labor costs per unit of output rose faster still.

Progress can still be made this year in slowing the rate of advance in our price level, and it is urgent that we do so. We must face squarely the magnitude of the task that lies ahead. A return to general price stability will require a national commitment to fight inflation this year and in the years to come.

For a time, we should be prepared to tolerate a slower rate of economic growth and a higher rate of unemployment than any of us would like. A period of slow growth is needed to permit an unwinding of the inflationary processes that have been built into our economy through years of neglect. I believe the American people understand this, and are prepared to make the sacrifices necessary to stop inflation.

There are, of course, risks that a period of slow economic expansion will lead to a gradual weakening of demand for goods and services, to a deterioration in the economic outlook, and to cumulative recessionary tendencies. Public policy cannot ignore this possibility. But the principal danger our country faces today is from the corrosive effects of inflation. If long continued, inflation at anything like the present rate would threaten the foundations of our society.

The proper course for public policy, therefore, is to fight inflation with all the energy we can muster.

Monetary policy must play a key role in this endeavor, and we in the Federal Reserve recognize that fact. Our actions this year have signaled a firm resolve to stick to a course of monetary restraint until the forces of inflation are under good control. We are determined to reduce over time the rate of monetary and credit expansion to a pace consistent with a stable price level.

However, monetary policy should not be relied upon exclusively in the fight against inflation. Fiscal restraint is also urgently needed. Strenuous efforts should be made to pare Federal budget expenditures in fiscal 1975. The Congress should resist any temptation to stimulate economic activity by a general tax cut or a new public works program.

Greater assistance from fiscal policy in the fight against inflation could, I believe, have dramatic effects on our financial markets. Even if no change were made in the course of monetary policy, interest rates would tend to fall and the stock and bond markets revive. Such developments would be of enormous benefit to the working of financial markets and to industries such as homebuilding that depend heavily on credit.

There may well be justification for governmental assistance to housing or other activities that are especially hard hit by a policy of monetary restraint. An expanded public-service employment program may also be needed if unemployment rises further. But government should not try to compensate fully for all the inconvenience or actual hardship that may ensue from its struggle against inflation. Public policy must not negate with one hand what it is doing with the other.

There are other actions that would be of help in speeding the return to general price stability. Fresh efforts should be made to bring our nation's business and labor leaders together to discuss their common interest in checking the wage-price spiral. A degree of governmental intervention in wage and price developments in pace-setting industries might also be helpful. In the construction industry, the pace of wage increases is once again accelerating, and the progress made earlier through the Construction Industry Stabilization Committee could easily be lost. Reestablishment of that Committee would be in the public interest. The Board of Governors would also urge the Congress to reestablish the Cost of Living Council and to empower it, as the need arises, to appoint *ad hoc* review boards that could delay wage and price increases in key industries, hold hearings, make recommendations, monitor results, issue reports, and thus bring the force of public opinion to bear on wage and price changes that appear to involve an abuse of economic power.

Encouragement to capital investment by revising the structure of tax revenues may also be helpful, as would other efforts to enlarge our supply potential. For example, minimum wage laws could be modified to increase job opportunities for teenagers, and reforms are still needed to eliminate restrictive practices in the private sector -- such as featherbedding and outdated building codes. We also need to enforce the anti-trust laws more firmly and stiffen penalties for their violation.

A concerted national effort to end inflation requires explicit recognition of general price stability as a primary objective of public policy. This might best be done promptly through a concurrent resolution by the Congress, to be followed later by an appropriate amendment to the Employment Act of 1946. Such actions would heighten the resolve of the Congress and the Executive to deal thoroughly with the inflationary implications of all new governmental programs and policies, including those that add to private costs as well as those that raise Federal expenditures.

This illustrious Committee has on past occasions provided timely and courageous leadership to the Congress and to the nation. The opportunity has arisen once again for the Joint Economic Committee to help our country find its way out of the great peril posed by raging inflation. Our people are weary, and they are anxiously awaiting positive and persuasive steps by their government to arrest inflation and to restore general price stability. The Federal Reserve pledges to you its full cooperation in your search for ways to restore a stable and lasting prosperity.

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