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Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I am pleased to appear before this Committee once again this year to discuss our nation's economic problems. Your main concern at these Hearings, as I understand it, is to assess our nation's needs and prospects for capital formation. Any such inquiry, I believe, should take as its starting point a general evaluation of economic and financial conditions as they exist at the present time.

The rampant inflation that we have been experiencing is having profound effects on the state of our economy -- on production, jobs, interest rates, and security prices. Thus far this year, the consumer price index has risen at an annual rate averaging 12-1/2 per cent. Wholesale prices of industrial commodities have risen much more steeply, at an annual rate of over 30 per cent. And prices of farm products and processed foods at wholesale, after declining in the spring, have recently moved up sharply again, in response to disappointing crop prospects.

Sustained double-digit inflation has pervasive implications for the performance of the economy. Despite sizable wage gains the real earnings of urban workers have eroded and consumer buying has suffered. Reports on business sales and profits are superficially favorable, but they have in fact been distorted by the inflation. Profits from domestic operations, after allowance for the effects of arbitrary accounting practices, have been generally disappointing. Financial relationships have also been thrown out of kilter. Nominal interest rates have soared because of the inflation premium demanded and received by investors; savers have shifted funds from the depository institutions to higher-yielding market instruments; stock prices have plummeted.

A still more ominous result of the inflation is the spread of doubts among businessmen and consumers. They do not know what their future expenses will be in dollar terms, nor whether their incomes will be sufficient to meet their costs. They do not know how they can protect their accumulated savings, the real value of which has been eroding despite a continuing buildup in dollar terms. They do not know what markets will be hurt by, nor what markets will benefit from, the higher and higher prices that people must pay. In short, the basic premises for the planning that American business firms and households customarily do have been upset, and the driving force of economic expansion has been blunted.

It is not surprising, therefore, that the physical performance of the economy has stagnated in recent months. Aggregate real output dropped in the first quarter of the year, as the nation was adjusting to the shortage and steeper prices of petroleum, and it seems to have weakened somewhat further during the second and third quarters. Industrial production has been less affected by the slump in demand, but in August it was about 2 per cent below the peak of last November. As a result of slower real output and sales, the demand for labor has tended to moderate. The length of the average workweek has declined somewhat and the growth in employment has slowed. The labor force has continued to expand, however, so that the unemployment rate has moved higher and reached 5.8 per cent in September.

The recent stagnation in real output, and the associated deterioration in employment conditions, are regrettable manifestations of the damage to our economy wrought by inflation. If these recessive tendencies persist, they must and will be resisted. But a vital point that has been commonly overlooked is that, given the pattern of demands in the economy, we have not had the capacity for significantly larger output over the past year. Idle capacity that could be used to produce more automobiles or housing units does not directly provide resources that can be used to produce the goods and services that are in stronger demand. The use of raw materials in these sluggish activities is reduced, to be sure, but the investment in plant and equipment -- and in the short-run, a considerable part of the labor force -- is not readily transferable to other endeavors.

The moderation in the nation's over-all output has already lasted a full year. Even so, some industrial materials, component parts, and equipment remain in short supply. Steel, aluminum, coal, plastics, paper, and basic chemicals are still counted among the shortages, as well as fabricated products such as electric motors, bearings, and metal castings. Supply conditions have gradually been improving, however, and price quotations for some sensitive industrial raw materials have declined of late. The weekly index of prices of such materials that the Federal Reserve maintains has dropped 18 per cent since the April peak, though it remains higher than at any time prior to last December.

I am hopeful that the availability of basic industrial materials will continue to improve. As it does so, there will be room for orderly expansion of output by industries that are heavy users of materials. Sizable investment programs are now underway in many of the basic materials industries, which will be adding significantly to their capacity in 1975 and subsequent years. Capital spending plans for 1974, for example, are indicated to exceed 1973 outlays by 42 per cent in the paper industry, 35 per cent in the primary metals industry, and 20 per cent in chemicals. These data reflect, of course, higher prices as well as larger physical quantities. Judging from reports on new appropriations and capital spending plans, further substantial increases in manufacturers' capital outlays are in prospect for next year.

It should be noted that the shortages in productive capacity have been spotty rather than general in character. We estimate that the basic materials industries have been operating, on average, at about 90 per cent of capacity thus far this year. This is somewhat below the 1973 operating rate, when supplies were exceptionally tight, but higher than in most other years during the past decade. For manufacturing generally, on the other hand, operating rates appear to be considerably lower.

Thus far this year, business capital expenditures have extended their rising trend, in real terms as well as dollars. Indeed, larger gains might be difficult to achieve in the short-run, since production of business equipment appears to be close to the limits of that industry's capability. The output of business equipment has grown little this year in the face of continued large increases of order backlogs. Preliminary readings suggest that capital spending will continue at a high level next year, but may not grow much in real terms. We need to encourage larger business capital formation in the interest of enlarging our productive capacity, modernizing industrial technology, and intensifying the forces of competition.

Many observers are forecasting a deepening recession in the United States' economy in the year ahead. On present evidence, I believe that they are unduly pessimistic. Capital spending, as I have said, can and should move ahead, particularly if tax incentives to investment are increased. Residential construction activity, which is now badly depressed, is likely to experience a revival in the year ahead. The expanded program of governmental assistance in the mortgage market announced by the President will contribute toward that end.

We cannot realistically expect a sustained resurgence of economic activity, however, until confidence in our nation's economy is restored. This, I believe, will require hard evidence that we are making progress in checking the disease of inflation. Frugality in spending by the Federal Government, and moderation in the wage demands of workers and in the pricing practices of business firms, are essential to regaining stability in the value of the dollar. Meaningful progress in combatting inflation would lead to a resurgence in consumer buying, a reduction in interest rates, a restoration of financial asset values, and a rebuilding of the optimism and confidence that engender greater willingness to save and to invest for the future.

Given the intensity of the inflation, as well as the excessive pressures on supply that have been present in key industries, the Federal Reserve has been striving for some time to hold down the growth of money and credit. The policy that we have pursued represents a middle course. We have tried to apply the monetary brakes firmly enough to get results, but we have also been mindful of the need to allow the supply of money and credit to keep expanding moderately.

Our policies have had considerable success in dampening the expansion of the monetary aggregates. So far this year, the narrowly defined money supply -- that is, currency plus demand deposits -- has grown at an annual rate of 4-1/2 per cent, in contrast to an average increase of 7 per cent during the preceding three years. Under a broader concept of money, defined to encompass also time deposits of commercial banks, except for their large negotiable certificates of deposit, the money supply has grown at a 7 per cent rate, in contrast to a 10-1/2 per cent average rate of increase during the 1971-73 period.

Thus, the monetary aggregates have continued to grow this year, albeit at a more moderate rate than earlier. However, the demand for money and credit has been much greater than the supply. Short-term business credit, as represented by borrowing at commercial banks and in the commercial paper market, rose at an annual rate of more than 20 per cent during the first eight months of 1974. New public offerings of corporate bonds in the capital market have been nearly double the volume of a year ago. As a result of the huge demand for borrowed funds, credit markets tightened and interest rates in both short- and long-term markets rose to an extraordinarily high level.

Such large credit requirements may seem puzzling in view of the recent sharp increases in reported corporate profits. But the profits being reported by many business firms are in part illusory. They are based on accounting principles devised for a non-inflationary environment, and they therefore fail to reflect adequately the impact of inflation on the cost of replacing the inventories, plant, and equipment that are, so to speak, consumed in the process of production. The profits actually available for expansion of investment, or for dividend payments, have not increased this year. On the contrary, they have declined significantly.

The most recent comprehensive data on profits relate to the second quarter. Total corporate profits before taxes, according to the Department of Commerce, were at a seasonally adjusted annual rate of $143.5 billion in that period. However, this figure includes the earnings of Federal Reserve Banks and other financial institutions. It includes the income generated by the operations of foreign branches and subsidiaries of American corporations. And it also includes the amounts paid by corporations on account of the Federal income tax. When we eliminate these several elements, we find that the after-tax profits of all manufacturing and other nonfinancial corporations were at a $67 billion annual rate in the second quarter, or 18 per cent above the corresponding quarter in 1973.

But this profits figure still fails to allow for the using up of low-cost inventories to support current sales. When the higher cost of replacing these inventories is deducted from reported profits, the amount remaining for all other purposes is 21 per cent below the level in the second quarter of 1973. Indeed, when so adjusted, recent corporate profits appear to be substantially lower than in the latter half of the 1960's. Moreover, these lower profit figures still make no allowance for the increasing amounts by which charge-offs for depreciation of plant and equipment have been falling short of replacement costs. That shortfall now amounts to many billions of dollars.

This depressing picture of corporate profits has been largely ignored by the general public, but not by the stock exchanges -- as the sorry price quotations for corporate shares testify. The recent inadequate level of corporate profits has forced corporations to borrow heavily, not only to finance their large and expanding capital expenditures, but often even to maintain their current production. The recent profit performance certainly provides too little incentive for investment in the new and more efficient capacity a growing economy will need.

At the very time when businesses have found it necessary to borrow extensively to finance their capital expenditure programs, Treasury and Federal agency borrowings through the securities markets have remained exceptionally large. State and local governments, too, have been raising a substantial volume of funds in credit markets. True, the credit flowing through the mortgage market has fallen considerably, and growth in consumer instalment credit has also slowed. In total, however, the volume of funds raised has been so large as to cause serious financial strains.

The strains in financial markets have been reflected not only in the rise of interest rates, but also in a widening of risk premiums among credit instruments of differing quality. Investor confidence has been shaken by the difficulties experienced by the Franklin National Bank, by the closing or reported losses of some foreign banks, and by the acknowledged financial problems of a few large corporations. Market rumors have aggravated the situation, and some sound borrowers have found it exceedingly difficult to obtain open-market credit.

The Federal Reserve has repeatedly made known its intent to fulfill its responsibilities as the nation's lender of last resort. We have provided large amounts of temporary assistance to Franklin National and small amounts to a few other institutions. This has helped to calm fears and has enabled financial markets to function in an orderly manner. But tensions still remain, and not a few lenders and investors are cautious about the credit risks they are willing to assume.

Short-term market interest rates, however, have recently been declining, and this is helping to alleviate pressures in financial markets. The decline in these sensitive rates reflects, among other factors, the present stance of monetary policy. In view of the fact that substantial moderation in the growth of money and credit has now been achieved, and in view also of the recent sluggishness in the over-all demand for goods and services, the Federal Reserve has felt justified in easing the pressure on bank reserves.

Federal Reserve open market operations have thus been somewhat less restrictive recently, and the interest rate on day-to-day interbank lending has dropped from over 13 per cent in early July to about 10-1/2 per cent currently. Other short-term interest rates, particularly the Treasury bill rate, have also declined appreciably. In early September, the Board announced a reduction in reserve requirements on large certificates of deposit maturing in four months or longer. This step was primarily designed to encourage banks to lengthen the maturity of their deposit liabilities, but it also released $500 million of bank funds for additional loans or investments.

It would not be appropriate for me to speculate how far the recent modest easing tendency in financial markets may go. I can assure you, however, that we at the Federal Reserve shall persevere in our basic policy of restraining the expansion of money and credit in the present inflationary environment. The supply of money and credit will continue to expand, but only at a moderate pace. If credit demands now subside, as may happen, market interest rates could decline further and institutionally determined interest rates, which traditionally lag behind market rates, could be expected to follow along.

Substantial progress in reducing interest rates, however, is unlikely to occur until borrowers and lenders are convinced that monetary policy is not alone in the struggle against inflation. I believe that the program proposed by the President on Tuesday, if it is strongly supported by the Congress, will help to provide that assurance. Excessive reliance on monetary policy to achieve the restraint needed in economic behavior has costly side effects. It pushes interest rates to unduly high levels; it causes distortions in financial flows; and it forces industries that are heavily dependent on credit to make severe adjustments in their scale of operations.

The homebuilding industry especially has experienced serious difficulties this year in an environment of rapid inflation, extraordinarily high interest rates, and taut monetary policy. Homebuilding was already suffering from inflated land costs and sharply rising materials prices and wage costs. Also, the supply of housing units available for rent or sale had increased to unusually high levels during 1973 as a result of overbuilding in the previous two years and lagging consumer demand. The escalation of interest rates and reduced supplies of mortgage credit this year have thus aggravated an already deteriorating situation.

Not only do high interest rates raise the cost of home financing, and thereby reduce the demand for housing, but they also induce individual savers to shift their funds into high-yielding market instruments and away from the financial institutions that traditionally supply mortgage credit. This summer, many savings and loan associations and mutual savings banks suffered outflows of funds. Inflows of household deposits to the commercial banks were also substantially lower. In consequence, these institutions were forced to cut back on their new commitments to make mortgage loans. The result has been a drying up in the availability of mortgage credit and a further sharp drop in housing starts.

The financing problems of the construction industry have been exacerbated, moreover, by the abrupt curtailment in the lending activities of real estate investment trusts. These are relatively new instituions, which depend heavily on open-market financing. Some of them became overextended and have experienced difficulty in rolling over their maturing debt. Much of this debt has had to be refinanced by the commercial banks, which the Federal Reserve has encouraged -- within the limits of banking prudence -- as part of its effort to protect the stability of the financial system.

The financial distortions and difficulties that are caused by excessive reliance on a restrictive monetary policy have not been limited to the housing and construction industries. They are felt also by other industries that must raise a large share of their funds in credit and capital markets. The electric utilities, in particular, have been having a difficult time this year. High interest rates, depressed stock prices, and increased investor caution in an uncertain environment have intensified the underlying financial problems of these companies.

Regulatory commissions have lagged in permitting the increases in electricity rates that are necessary to match the sharp increases in fuel and other operating costs, so that the earning capacity of the utilities has been badly eroded. As a result, the quality ratings of the bonds issued by some utility companies have been reduced, and this development has added to the cost of their borrowed funds. Moreover, as prices of utility stocks have fallen, in many cases far below book value, it has become very difficult and expensive for the utilities to raise new funds through the sale of stock.

In recent months, many utilities have announced large reductions or postponements in their planned capital expansion programs. To some degree, cutbacks of previous plans may be warranted by the efforts of business firms and households to conserve on the use of energy. But inability to raise the necessary financing has also been a major consideration in numerous instances, and this could lead to serious problems in the future. If the supply of electric power is to be adequate for the nation's needs in the years ahead, the utilities must be in a financial position to invest heavily in new capacity.

In view of the financing problems that have developed for the utilities, for homebuilding, for the thrift institutions and real estate investment trusts, and perhaps for other industries, some economists and legislators have suggested that there is need for a governmental program of direct credit allocation and control. I would strongly oppose such a course of action. Special programs of credit assistance may well be needed, such as those already in operation and newly announced by the President for housing. But to embark on a policy of allocating credit to particular individuals and business firms by governmental fiat would be a serious mistake, because it would not and could not work.

In view of the variety of financial channels available to most borrowers and lenders, controls would need to be rather comprehensive if they are to be at all effective. They would need to include not only the banks but other institutional lenders, such as the thrift institutions, finance companies, insurance companies, and pension funds. They would need to cover not only the lending by financial institutions, but also the financing done through the public markets for debt and equity securities. They would probably need to regulate not only domestic lending and borrowing, but also access to lending and investing alternatives abroad. This would be a task of enormous administrative complexity.

Nor is even this the entire problem. The ultimate difficulty is that by disrupting the orderly processes of financial markets, such a program could create serious industrial imbalances and bring the economic activity of some industries and communities to a virtual halt. In my judgment, there is no good substitute for the decision-making process provided by our highly developed, sensitive, and intensely competitive financial system.

Nevertheless, we at the Board recognize the need to avoid using our nation's scarce banking resources for unproductive purposes. Last month the Board received a report prepared by the Federal Advisory Council -- a statutory body under the Federal Reserve Act -- that suggested a set of priorities that should be followed under current conditions in bank lending. In releasing the Council's guidelines, the Board noted that limited credit resources best serve the public interest when used for purposes that encourage expansion of productive capacity, sustain key sectors of national and local economies, provide liquidity for sound businesses in temporary difficulty, and take account of the special problems of the homebuilding industry and of small-and medium-sized businesses.

In the Board's judgment, the Council's statement on lending priorities can be helpful to bankers. We have sent it to all member banks in the United States and we will be following their response. I would urge that other types of financial institutions also review their lending policies with a view to the special needs of the current economic and financial environment. But any such effort must have considerable flexibility, in order to provide for the wide variety of circumstances that our thousands of institutions and millions of borrowers inevitably face.

In conclusion, I would readily grant that there are numerous imperfections in the behavior of our financial system. Institutional reforms are needed. The Board supports the principles of the proposed Financial Institutions Act, which aims to strengthen depository institutions and to promote greater competition among them. But it is also necessary to reform our regulatory structure so that the stability of the financial system may be enhanced. This need is receiving much attention at the Federal Reserve Board and elsewhere, just as stronger tax incentives for investment are concerning Treasury and other government officials.

I must add, however, that in the Board's judgment, the main obstacle to the efficient functioning of our financial system is the raging inflation that we are experiencing. Inflation must be brought under control, not only through the exercise of monetary and fiscal discipline, but by a crusade in which all citizens participate, as the President has proposed. I am confident that the battle against the disease of inflation can be won. As meaningful progress is made in doing so, interest rates will return to lower and more normal levels, the tensions in financial markets will abate, and reasonable financing will be found for the many worthwhile investment projects that a healthy, private economy always generates.

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