For release on delivery

Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

February 25, 1975

I am pleased to meet with this Committee today to present the views of the Board of Governors on Senate Concurrent Resolution 18.

This Resolution consists of two parts. The first part directs the Federal Reserve System to "take appropriate action in the first half of 1975 to increase the money supply at a rate substantially higher than in recent experience. . . " The second part of the Resolution directs the Federal Reserve to "maintain long-run growth of the money supply commensurate with the economy's long-run potential to increase production, so as to effectively achieve the goals of maximum employment and stable prices."

To appraise the need for this Senate Resolution, it is essential to understand our nation's economic and financial condition and the recent course of monetary policy.

Our economy today is suffering from a serious recession. That such a development would take place, sooner or later, has long been clear to students of business cycles, who watched with increasing concern the gathering momentum of inflation. This round of inflation got under way in our country in 1964; its pace quickened in subsequent years with the piling up of Federal deficits and the devaluation of the dollar, and it became dangerously rapid in 1973 and 1974. As is characteristic of the late stages of an inflationary boom, speculative activities flourished, particularly in real estate markets, while industrial efficiency languished. During 1973 and much of 1974, purchasing agents found themselves scrambling for materials, component parts, and equipment; order books of business firms became over-full; delays in deliveries became longer and more frequent; costs and prices soared; demands for credit increased rapidly and outran available supplies.

As a result of these developments, our nation's productive capacity suffered a setback. Consumer purchasing power eroded; the real value of the wages, savings deposits, pensions, and life insurance policies of the American public diminished. Corporate profits declined -- a fact that received little notice because of accounting techniques that had been designed for inflation-free times. Financial markets underwent exceptional stresses and strains, and interest rates soared to record levels. In short, inflation led to this recession, as it has done time and again in the past. And what we are now experiencing, most other industrial countries are likewise experiencing; for the inflationary boom of recent years reached world-wide proportions.

In our country, the Government has already taken some significant actions to mitigate the forces of recession that emerged last fall and that since then have spread across the economy. There is now a need for additional measures to cushion the recession and to encourage early recovery in economic activity. Yet, as we go about this urgent task, we cannot ignore the longer-run implications of the policies that we undertake. Defeat of inflationary forces must remain a major goal of public policy. Unless we keep this firmly in mind, we may have to contend with still more serious economic troubles a year, two, or three from now.

In recent months, the Federal Reserve has taken numerous steps to reduce interest rates and to enlarge supplies of credit, and thus moderate recessionary forces. Open market operations became more accommodative last summer, and short-term market interest rates began to move down promptly from the exceptionally high levels reached in July. By early autumn, evidence had accumulated that economic activity was weakening and that advances in commodity prices were beginning to moderate. Open market operations, therefore, were persistently directed towards more ample provision of reserves to the banking system.

Of late, open market policy has been reinforced by other monetary instruments. The discount rate was reduced on three occasions -- in December, January, and again early this month -- from 8 per cent to 6-3/4 per cent. Reductions in member bank reserve requirements were also ordered -- in September, November, and January, releasing a total of nearly $2-1/2 billion of reserves to the banking system.

These easing actions by the Federal Reserve were taken during a period of weakening demands for private credit. As auto sales slumped, so also did the growth of consumer instalment credit. In fact, on a seasonally adjusted basis, total instalment credit outstanding has actually been falling since October of last year. As industrial production declined, so also did business needs for short-term financing. Moreover, the rate of expansion of mortgage credit has continued to run far below the pace of 1973.

In these circumstances, the actions taken by the Federal Reserve since last summer to augment the supply of loanable funds have had a dramatic effect on short-term market interest rates. For example, the Federal funds rate -- the rate banks pay when borrowing reserves from one another -- has declined by more than 7 percentage points from the peak level registered in July of last year. The interest rate on short-term commercial paper has declined from over 12 per cent last July to around 6 per cent now. And the prime rate has fallen from 12 to 8-1/2 or 8-3/4 per cent.

Long-term market interest rates have also declined, although much less than short-term rates. With inflation continuing and still in prospect, a sizable inflation premium inevitably attaches to long-term interest rates. Moreover, corporations have issued exceptionally large amounts of long-term bonds in recent months, in part because of their desire to lengthen debt and thereby improve their liquidity position.

The beneficial effects of easier conditions in financial markets are not registered solely in the behavior of interest rates. For example, commercial banks responded initially to the greater availability of reserves by repaying borrowings from the Federal Reserve and by taking other steps to improve their liquidity. Many banks became overextended during the credit expansion of 1971-74, and a strengthening of their financial position was needed to lay the basis for subsequent expansion of lending.

The liquidity of nonbank depositary institutions has also improved. Enlarged inflows of deposits to savings and loan associations have permitted these suppliers of home mortgage funds to reduce their indebtedness and to replenish liquid assets. The full benefits of these developments for housing finance will not be felt for some time, but the improved deposit inflows have already had an effect on mortgage rates. Rates on new conventional home mortgages have typically declined by about a full percentage point from their peaks of early autumn, and lenders are also becoming more active now in seeking out borrowers.

In short, financial conditions have eased on a broad front. The liquidity of banks and thrift institutions has improved; short-term interest rates have dropped sharply; long-term interest rates have also come down; an enormous volume of long-term securities has been successfully marketed; tensions and uncertainties that afflicted financial markets earlier last year have diminished; and stock prices have been rising briskly of late.

Thus, developments in financial markets have been laying the basis for recovery in economic activity, and that process is continuing. Interest rates have fallen further in recent weeks, even though Treasury financing needs have grown and market participants have begun to anticipate the massive Federal deficits that, unhappily, are now in prospect.

As I have already noted, these needed improvements in financial markets have been actively encouraged by Federal Reserve policies. Nonetheless, concern is being expressed in some quarters that we are not doing enough to stimulate monetary growth. The Board does not share this judgment. Our is still largely a free economy, and a reasoned evaluation of Federal Reserve policy must take into account the vital role played by decisions of private borrowers and lenders.

The Federal Reserve can supply the banking system with reserves through open market operations or through reserve requirement changes; but if banks choose to repay debt or rebuild their liquidity, these actions will have little impact on the public's money supply. The Federal Reserve can have a marked influence on short-term interest rates and may also have some indirect influence on other terms of credit. But it cannot force businesses or consumers to borrow from their banks, and thus to expand the volume of bank loans. The Federal Reserve cannot force people to hold money in the form of demand deposits, when they prefer to hold their transactions or precautionary balances in income-earning assets. Nor can the Federal Reserve force people to use their available cash balances more quickly or more liberally. These limitations are inescapable and they need to be understood.

Of late, the growth of monetary aggregates has reflected the cautious attitude of banks, businesses, and consumers. Despite a series of expansive monetary actions by the Federal Reserve, the narrowly-defined money stock (M_1) -- that is, currency plus demand deposits -- grew at an annual rate of only 4-1/2 per cent in the final quarter of 1974. In January of this year, moreover, business demand for bank loans was unusually weak, and a decline occurred in M_1.

Broader measures of money, on the other hand, have shown greater strength. With market interest rates declining, net inflows of consumer-type time and savings deposits at banks and at nonbank thrift institutions have improved markedly. Growth of M_2 -- which also includes consumer-type time and savings deposits at commercial banks -- was at an annual rate of 7 per cent in the fourth quarter, compared with a 4-1/2 per cent rate in the third. A still broader measure of money that includes currency plus all deposits at all financial institutions --

that is, commercial banks, savings banks, savings and loan associations, and credit unions -- showed rates of growth of 5-1/4 and 8-1/4 per cent in the third and fourth quarters of 1974, respectively.

Nonetheless, the growth rates of monetary aggregates have of late fallen short of what the Federal Reserve desired. In recent months, therefore, the Federal Open Market Committee has taken progressively stronger steps to encourage a faster pace of monetary and credit expansion. For example, at its meeting on October 15, the directive issued by the Committee to the Manager of the Open Market Account called for "resumption of moderate growth" of the monetary aggregates. Again, on January 21 of this year, the Manager was directed to achieve reserve and money market conditions consistent with "more rapid growth in monetary aggregates than has occurred in recent months."

The Committee's actions have resulted in a progressively more ample provision of bank reserves, as is evidenced by the sharp decline since late summer in the interest rate that banks pay when they borrow reserves from one another. Since the December meeting of the Open Market Committee, the Federal funds rate has dropped another 2-1/2 percentage points. There are few precedents for so large a decline in a period of just 10 weeks.

Forces have now been set in motion that will, I believe, soon result in a quicker pace of monetary and credit expansion. Actually, that process may already be underway. Early this month, the narrowly-defined money stock -- which had declined in January, as I noted earlier -- began to increase once again, and the rising trend has continued in the latest week.

As my review of recent monetary policy actions indicates, the Federal Reserve intends to encourage the expansion in supplies of money and credit needed to mitigate recessionary forces and encourage early recovery in economic activity. However, we have not thrown caution to the winds, and I firmly assure you that we shall not do so. True, inflationary pressures of late have shown welcome signs of moderating. But the menace of inflation is by no means behind us. Let us not lose sight of the fact that the general price level rose at an annual rate of 14 per cent in the fourth quarter of last year. Let us not lose sight, also, of the fact that the Treasury's demands for credit to finance the deficit are enormous, that private credit demands in the bond market are even now extraordinarily large, and that over-all private credit demands will expand when economic activity recovers. Unless we move carefully and prudently, we might well find that rising credit demands are producing an explosion of money and credit that could wreck all chances of lasting recovery. We must not let this happen.

Let me turn now, therefore, to the Resolution before this Committee today. The Board has no quarrel with its broad objectives, nor would the spirit of the Resolution conflict with the current aims of monetary policy. As I have already noted, the thrust of monetary policy over recent months has been consistently directed toward faster growth of the monetary and credit aggregates in order to enhance prospects for recovery. At the same time, we have avoided excesses that could endanger our chances for lasting prosperity with a reasonably stable dollar. Since these are precisely the policies that the Board intends to continue to pursue, it is not clear why Resolution 18 is needed.

I would remind you, also, that the Federal Reserve System, as an instrumentality of Government, is required to pursue the goals expressed in the Employment Act of 1946, which specifies "maximum employment, production and purchasing power" as objectives of national economic policy. To be sure, the language of the Employment Act is less clear than it should be on the need for a stable price level. But, as a practical matter, the Employment Act has long been interpreted by the Federal Reserve and other governmental agencies to mean that reasonable price stability must be a high objective of public policy. Resolution 18, therefore, adds nothing new to the objectives of Federal Reserve policy as already defined by statute.

Adoption of the Resolution could, however, have damaging operational consequences. In the first place, the two parts of the Resolution may collide with one another. In explaining the Resolution to his colleagues in the Senate, Senator Proxmire observed that the second part of the Resolution "will help the Fed resist any future political pressure either from the White House or the Congress to overaccelerate to achieve short run gains at the cost later on of still another round of inflation, high interest rates, recession." This is a very perceptive comment, and I hope that the Committee will ponder this comment when it looks closely at the first part of the Resolution which could be interpreted to mean that the Federal Reserve is being urged by the Congress to take much stronger monetary measures than it has already taken.

The Board regards Resolution 18 as dangerous for still another reason -- the fact that the Resolution directs the Federal Reserve to pay attention to one financial factor only, namely, the money supply. As this Committee knows, the Federal Reserve System has given very close attention in recent years to the behavior of monetary aggregates. We are well aware that an expanding economy needs an expanding supply of money and credit, and that any protracted shrinkage of the money stock could lead to or exacerbate a shrinkage of economic activity. We are also well aware that excessive growth of money will lay the base for a new wave of inflation. But if the Federal Reserve's policies were to be focused solely on the money supply -- as the Resolution seems to direct -- our financial system would be placed in jeopardy. The risk would become especially great if the "money supply" were interpreted to mean merely currency plus demand deposits -- which is the meaning that emerges from Senator Proxmire's explanatory statement to the Senate.

Let us not lose sight of the fact that the public's demands for currency, for demand deposits, for savings deposits, and for a host of other liquid assets are constantly changing. Financial technology in our country has developed very rapidly in the past twenty years. As a rule, consumers and businesses no longer hold all, or even most, of their spendable funds as currency or demand deposits. More and more corporate treasurers have learned how to get along with a minimum of demand deposits; a large part of their transactions and precautionary balances are nowadays placed in interest-bearing assets -- negotiable certificates of deposit, Treasury bills, commercial paper, short-term municipal securities, and other forms. Consumers, too, have learned to keep excess funds in savings deposits at commercial banks, shares in savings and loan associations, certificates of deposit, Treasury bills, and other liquid instruments, and they shift their liquid resources among these assets. The result is that no single concept of money any longer measures adequately the spendable funds held by the public.

For example, the narrowly-defined money stock rose by 4-1/2 per cent during 1974. But this concept of the money supply has lost much of its earlier significance. If the definition of money is broadened to include consumer-type time and savings deposits at banks and thrift institutions, the total increased last year by 6-3/4 per cent. If large-denomination negotiable certificates of deposit are also added, the total rose by almost 9 per cent -- or nearly twice the growth rate of the narrowly-defined money supply.

In view of such variations, the Federal Reserve must conduct monetary policy with an eye on a family of monetary aggregates, the behavior of whose members varies remarkably. But we must also give careful attention to the level of interest rates on mortgages and other loans, the liquidity position of financial institutions and the general public, and to other economic and financial factors. This is necessary because the willingness to use money, no matter how that elusive term is defined, depends heavily on the cost and availability of borrowed funds, and the state of confidence among businessmen, investors, and consumers. Also, as the nation's central bank, the Federal Reserve can never lose sight of its role as a lender of last resort, so that financial crises and panics will be averted.

The conduct of monetary policy must also take account of the position of the dollar in international markets. When developments in exchange markets result in large declines in the value of the dollar, as they have since last September, prices of imported products are forced up and inflationary pressures are intensified. Furthermore, undue fluctuations in exchange rates affect adversely the willingness and ability of traders to function in international markets. Worse still, since the dollar is still the basic yardstick in international transactions, a protracted erosion in the international value of the dollar could weaken world trade, and it would certainly undermine the prestige of the United States in world affairs. In discharging our responsibilities with respect to the international value of the dollar, we at the Federal Reserve may at times, therefore, need to deviate temporarily from our longer-run objectives with regard to the monetary aggregates.

In short, economic and financial conditions keep changing, public preferences for liquid assets keep changing, and so what constitutes an appropriate response of monetary policy must also change. If we focused solely on the money supply, or guided our operations entirely by the monetary aggregates, the Federal Reserve would fail to fulfill its responsibilities for helping to achieve our nation's economic goals.

Finally, the Board objects to the last paragraph of Resolution 18, which calls for semiannual reports to the Congress by the Federal Reserve of its plans for future monetary policy. Such a requirement could limit the flexibility of monetary policy in responding to unexpected developments, and it could undermine the capacity of the Federal Reserve to exercise its best judgment in adapting policies to changing circumstances. Such a requirement would also provide opportunities for sophisticated market participants to gain at the expense of others by using the information they would receive on the anticipated course of monetary policy.

I do not mean to convey by these comments that the Board is opposed to consultations with the Banking Committees. On the contrary, we welcome the opportunity to report to the Congress, and as frequently as the Congress may desire, on monetary and financial developments and on the policies that we are pursuing. We would indeed welcome the advice and counsel of this Committee and of other Congressional committees with responsibilities in the field of economic stabilization policy. But a more detailed involvement of the Congress in the implementation of monetary policy is, I believe, unwise.

In conclusion, Resolution 18 raises in the Board's judgment momentous issues with respect to the role of the Federal Reserve in the economic life of our nation, whether the Federal Reserve's traditional insulation from political pressures will continue, whether resistance to inflation may not further diminish, and whether the dollar will remain a respected currency around the world.

If the Congress should seek through Resolution 18 to become deeply involved in the implementation of monetary policy, it would enter an intricate, highly sensitive, and rapidly changing field -- with consequences that could prove very damaging to our nation's economy. We therefore hope that this Committee will consider very carefully the consequences for our national welfare that could result from adoption of this Resolution.

* * * * * *