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Statement by

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prepared for the

Committee on the Budget

House of Representatives

March 12, 1975

I am glad to meet with this Committee today to discuss with you the difficult fiscal and economic problems confronting this nation.

The fiscal decisions which this Committee and the Congress must face are of profound importance to our nation's future. A prompt tax reduction is needed to cushion the recession now afflicting our economy. But we must keep in mind that the Federal deficit in prospect for this and the forthcoming fiscal year is already huge. A substantial further increase could put excessive strains on money and capital markets, push up the rate of inflation later on, and reinforce other long-run trends that have been adversely affecting the performance of the American economy. The ways in which we as a people deal with these problems in the months ahead may well determine whether our country will return to a stable prosperity or continue to drift in ways that are gradually sapping the strength of our economic system.

In my testimony today, I shall discuss, first, our immediate economic problems; next, some disturbing longer-term trends that require attention; and finally, the fiscal issues that have become the awesome responsibility of this Committee under the Congressional Budget Act of 1974.

held up well thus far this year. There is also some evidence that the physical volume of total business inventories is now declining. Any such decline is bound to have a temporary depressing effect on production and employment, but it is an essential precondition for an upturn in business activity.

A solid recovery, however, will require a turnaround in housing and in spending for new plant and equipment by our nation's business firms. New mortgage loan commitments of thrift institutions have risen appreciably in recent months, the inflow of funds to these institutions is continuing at a rapid rate, and new housing starts also increased somewhat in January. A pickup in homebuilding may therefore be underway soon. But some businesses are still postponing or canceling plans for constructing new facilities or for installing new machinery and equipment. Larger business expenditures for fixed capital are now needed to add to the number of jobs and expand personal incomes, thereby strengthening consumer purchasing power. Larger investment expenditures are also needed to provide, later on, the modernized industrial plants and the additional productive capacity that are essential to combating inflationary pressures and raising our living standards.

Monetary policy has responded to the weakening in economic activity by promoting easier financial conditions. Federal Reserve open market operations began to be more accommodative last summer. As the year progressed, they were increasingly directed towards a more ample provision of reserves to the banking system. More recently, open market policy has been reinforced by other monetary instruments. The discount rate was reduced on four occasions, and three reductions were made in member bank reserve requirements.

These policy actions, together with weaker demands for credit by businesses and consumers, have resulted in a sharp decline of short-term market interest rates. For example, the Federal funds rate -- that is, the interest rate banks pay when borrowing reserves from one another -- has declined from a peak of 13-1/2 per cent registered in July of last year to less than 6 per cent now. The interest rate on short-term commercial paper has declined from over 12 per cent last July to around 6 per cent. The prime loan rate charged by banks has declined by about 4 percentage points. As a result of these reductions, short-term interest rates in the United States have recently been lower than in any other major industrial country.

Long-term interest rates have also declined, although much less than short-term rates. Lenders are still demanding a sizable inflation premium to supply long-term funds, and they are doing so in other countries as well as in the United States. Actually, long-term interest rates in our country are lower than in any major industrial nation except Switzerland.

The beneficial effects of easier conditions in financial markets have not been confined to the behavior of interest rates. Commercial banks have repaid their borrowings from the Federal Reserve and have taken other steps to improve their liquidity. Liquidity positions of nonbank thrift institutions have also improved, and mortgage credit has become more readily available. A large volume of long-term securities has been successfully marketed by business corporations and municipal governments; tensions and uncertainties surrounding financial markets earlier last year have diminished; and stock prices of late have been rising briskly.

Thus, the course of monetary policy since last summer has fostered conditions in financial markets that are helping to mitigate recessionary forces and to encourage early recovery in economic activity. However, in view of the continuing seriousness of the problem of inflation, the Federal Reserve's actions to expand the supply of money and credit have been disciplined by prudence. True, inflationary pressures of late have shown welcome signs of moderating; for example, the overall index of wholesale prices has declined in each of the past three months. But wage increases are continuing to exceed productivity changes by a wide margin, and the consumer price level is still rising at an annual rate of about 8 per cent. The menace of inflation is by no means behind us. Let us not lose sight of the fact that the severe recession in which we find ourselves is largely a consequence of neglect in dealing with our persisting inflation. This is one of several longer-range problems to which I want to direct this Committee's attention.

Inflation has been a concern of this country, as well as others, throughout most of the period since World War II. However, the upward march of prices began to accelerate in the middle 1960's, and it became dangerously rapid in 1973 and 1974. As is characteristic 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 was 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.

We cannot realistically expect to regain lasting prosperity until businesses and consumers see some end to the inflation that has been damaging our economy. Public policy, both now and in the future, must not lose sight of this hard-learned truth.

A major factor responsible for the accelerating inflation of the past ten years is fiscal laxity. The current round of inflation began when the Federal Government embarked on a highly expansive fiscal policy in the middle 1960's. Large tax reductions occurred in 1964 and the first half of 1965, and they were immediately followed by a rapid increase of Federal spending. New and substantial tax reductions occurred again in 1969 and 1971, and they too were followed by massive increases of expenditures.

Deficits have therefore mounted, and they have persisted through good years and bad. In the last five complete fiscal years -- that is, from 1970 through 1974 -- the Federal debt held by the public, including obligations of the Federal credit agencies, rose from $304 billion to $412 billion, an increase of 35 per cent. The huge deficits of recent years added enormously to aggregate monetary demand for goods and services, but they added little to our nation's capacity to produce. They have thus been directly responsible for a substantial part of the inflation problem.

While reductions in tax rates contributed to chronic deficits, by far the largest source of the problem came from increases of Federal expenditures. It may be useful to remind ourselves of what has recently happened to the rate of Federal spending.

Total Federal expenditures did not reach the $100 billion level until fiscal 1962, or nearly 200 years after the founding of the republic. By fiscal 1971, only nine years later, Federal spending rose another $100 billion and thus passed the $200 billion mark. This fiscal year, or only four years later, the $300 billion mark will be passed, and -- at the rate we are going -- the $400 billion level may be exceeded in another two years, that is, in fiscal 1977. If this trend of acceleration persists, we will soon be adding $100 billion or more to the total of Federal spending every year.

The huge and persistent increases in governmental expenditures, besides being a major cause of intensifying inflationary pressures over the past decade, have also been responsible for a weakening of individual enterprise in this country. This is the second longer-run problem that our nation must confront.

Over the past quarter century, governmental programs have increased markedly the share of national output going to persons who are not productively employed. Transfer payments by all governmental units -- in such forms as public welfare, social security benefits, unemployment insurance, and other public assistance -- have risen about twice as fast as total wages and salaries, so that they now amount to about one-fifth of the aggregate of wage and salary disbursements. Twenty-five years ago, a typical worker with three dependents gave up only about 1 per cent of his gross weekly earnings in Federal income and social security taxes. Since then, that fraction has risen steadily and it reached 13 per cent in 1974.

Any large increase in the absorption of private incomes by Government is bound to raise questions about economic efficiency. In 1929, governmental spending at all levels accounted for less than 11 per cent of the dollar value of our nation's total production. The corresponding figure rose to 20 per cent in 1940, 30 per cent in 1960, and 36 per cent in 1974. Higher taxes, in particular, pose a threat to individual incentives -- all the more so when taxes are levied on persons who work and produce, and the funds are then transferred to others who remain idle. We are, and I hope that we will always remain, a compassionate people. But if we continue to seek rapid growth of our national economy, as I believe we still do, we can ill afford to neglect the fundamental precept that there must be adequate rewards to stimulate individual effort.

Nor can our nation afford to neglect the deterioration in corporate profits that has taken place over the past decade or more. This is another longer-run problem of major importance. The ratio of profits of non-financial corporations to the corporate gross product has been declining rather steadily for many years, and profits in the aggregate have been far too low in recent years to supply the financing needed for vigorous expansion of capital investment.

Last year, the pre-tax profits of all non-financial corporations from their domestic operations may appear to have been about 16 per cent higher than in 1973 and 45 per cent higher than in 1972. However, the dominant factor in this rise was an extraordinary increase in inventory profits -- an element of earnings that is illusory. It stems from the fact that the accounting practices of many corporations still do not allow for the fact that inventories used up in production must be replaced at higher prices during a period of inflation. As a consequence, costs of operations have been understated, and fictitious profits have been created that are being taxed by the Federal Government.

Once this illusory inventory profit is eliminated, we find that the after-tax domestic profits of nonfinancial corporations did not rise last year. On the contrary, they declined by 20 per cent, and were smaller than eight or ten years earlier -- when the dollar value of the output of these corporations was about half what it is now. Moreover, when allowance is made for the fact that depreciation schedules for fixed capital are also based on historical costs -- rather than replacement costs -- and thus contribute yet another illusory element to book profits, we find that the picture of corporate profits is still darker.

The slump in corporate profits during the past decade is a major reason why business capital investment has been inadequate to maintain the long-term growth of productivity in this country. This is the fourth longer-range problem to which I want to call the Committee's attention.

The trend of productivity improvement is tending to flatten out. During the past decade, the average annual increase of productivity in the private nonfarm economy was less than 2 per cent, compared with nearly 3 per cent in the previous ten years. Within the past decade, the rate of improvement in productivity diminished also. This development has a significant and cumulative bearing on the living standards of our people, and also on the impact that rising wage rates have on costs of production and prices.

There has been still another ominous consequence of deteriorating business profits -- namely, a decline in the financial strength of many of our nation's business firms. This is the fifth longer-term trend that requires attention.

Years ago, our nation's large business corporations financed much of their capital investment from internal sources -- that is, from profits and depreciation reserves. For more than a decade, however, dependence on borrowed funds has been rising steadily.

This growing reliance on borrowed money means that the debt owed by business firms has kept growing relative to their equity position. Moreover, a large part of the indebtedness has been in the form of short-term obligations, and these in turn have grown much more rapidly than holdings of current assets. As a consequence, many large businesses no longer have the strength or resilience they once had in the face of economic and financial adversity.

The sixth longer-range problem to which I wish to draw your attention is the foreign exchange value of the dollar. Actually, the dollar began weakening many years before it was formally devalued in 1971. Before that, our balance of payments had been in deficit for a prolonged period, and the dollar holdings of foreign central banks kept rising steadily. The devaluation of 1971 and also that of 1973 were thus a consequence of trends that had been underway for many years.

Since the second devaluation in 1973, the foreign exchange value of the dollar has fluctuated fairly widely. For example, since last September, the average value of the dollar has fallen by about 7 per cent in relation to the currencies of ten major countries. Such fluctuations make it more difficult for foreign traders and investors to make rational plans for the future. We must bear this in mind, and also the fact that any appreciable further decline in the external value of the dollar would add to our domestic inflation problem.

Let me turn now to the implications for public policy of our immediate and longer-range economic difficulties.

The most urgent need at the present time is to cushion the recession. Action to reduce personal income taxes, and to increase the investment tax credit, is overdue.

The House has already acted; and I hope that the Senate will soon reach its decision -- either along the lines recommended by the President or as embodied in the House bill. If the stimulus to the economy thus provided proves insufficient, additional stimulus could be provided two or three months later.

The principle underlying the President's fiscal program should, however, be kept clearly in mind. A temporary boost to aggregate demand is needed to alleviate recessionary forces, but we must try to accomplish this without adding to Federal deficits over the longer-run.

The Tax Reduction Act of 1975 passed by the House (H.R. 2166) is consistent with this principle, since it provides for temporary tax reductions. However, a variety of increases in expenditures are meanwhile in the making, and sentiment is also developing for larger and permanent tax reductions. I have become deeply concerned, therefore, about the size of our prospective deficits, and the threat posed by these deficits for our money and capital markets and for our longer-run inflationary trend.

Let us take stock of where we are and what may happen in the forthcoming fiscal year. In the current fiscal year, total Federal outlays will probably exceed revenues by much more than the $35 billion estimated in the President's budget message. This enormous deficit is regrettable, but it reflects largely the effects of the recession on Federal tax receipts and on expenditures for unemployment insurance and related programs. In any event, there is no practical means of reducing significantly the deficit for fiscal 1975 at this late stage.

For fiscal 1976, the unified budget deficit projected by the Administration just a few weeks ago totaled $52 billion, but that figure is merely serving as the base on which increases are being built. The official Administration estimate was raised some days ago to about $54 billion, on account of the release of previously frozen highway and hospital construction funds and also because Congress did not raise the price of food stamps. The President has just requested almost $2 billion additional funds for public service jobs and summer youth employment. But that is not the end of the matter. If H.R. 2166 is enacted, in lieu of the Administration's tax program, the deficit in fiscal 1976 will rise another 5 or 6 billion dollars, thus bringing the total to over $60 billion. Moreover, if the great bulk of the rescissions, deferrals, and other spending curbs specified in the Administration's budget are rejected by the Congress, the deficit will reach about $75 billion. If off-budget outlays and those of Government-sponsored enterprises are also added, as I believe they should be, the figure mounts to over $90 billion. And if the Congress provides funding for programs beyond present estimates, or if revenues fall short of present projections, the Federal deficit to be financed in the upcoming fiscal year could exceed $100 billion.

I cannot stress too strongly the dangers inherent in a deficit of anything like that magnitude. Much of the financing of the deficit will occur at a time when private credit demands will probably be strengthening. Enormous strains may therefore be placed on the money and capital markets. This means that interest rates may begin to shoot up, that many private borrowers may be crowded out of the market, that savings funds may once more be diverted from mortgage lenders, and that the stock market may turn weak again.

With deficits mounting, the Federal Reserve will probably be subjected to pressure from all sides to follow a highly expansive monetary policy. Every citizen should recognize, however, that unbridled monetary and credit expansion in circumstances of this kind could have disastrous consequences. Short-term interest rates might be held down for a short time by permitting the supply of money and credit to increase apace with soaring credit demands. But long-term interest rates would soon be likely to move up rather briskly, because lenders and borrowers alike would realize that a new and even more virulent round of inflation may soon follow.

I must advise this Committee that the only responsible course now available to the Federal Reserve is to pursue a moderate path of monetary expansion. As I see things, the time remaining for getting control of our nation's long-run problems is growing short. Certainly, the people of this country are weary of inflation; they are confused and disturbed by the huge budget deficits that are in the making this fiscal year and next; and they are anxiously awaiting evidence that their Government can and will take the necessary steps to restore a stable prosperity.

I hope, therefore, that this Committee will focus a good deal of its attention on the course of public policy needed to cope with the serious longer-range problems facing the nation, as well as on the actions needed now to encourage early recovery of business activity.

Solving these longer-range problems will require a better measure of discipline in Federal finances. Actions taken to stimulate the economy now must not erode the tax base, and we must avoid setting off another spiraling rise of Federal expenditures. Ways must be found to curb the ever increasing share of the national income absorbed by governmental programs. Ways must be found also to strengthen business profits and the state of business finances, and to increase the incentives for expansion of productive capacity and for modernization of our nation's industrial plant.

Above all, the Congress needs to keep firmly in mind that the task now facing our country is not only to hasten the process of economic recovery, but also to lay the basis for a lasting prosperity.

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