

February 28, 1975

The Honorable Gaylord Nelson
Chairman
Select Committee on Small Business
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

I regret very much that, because of illness, I was unable to appear before your Committee on Wednesday, February 5. As you know, because of the brief period between the announcement of the hearings and the dates when they were held, I had intended to deliver a statement that would not have represented the official views of the Board of Governors, but would have reflected comments received from various members of the Board and of the Board's staff.

Inasmuch as this statement is now ready, I am submitting it with this letter in the hope that it may prove useful to the Committee in its deliberations. Your courtesy in this matter is sincerely appreciated.

Sincerely yours,

(Signed) George W. Mitchell

George W. Mitchell

Enclosure

Statement by
George W. Mitchell
Vice Chairman
Board of Governors of the Federal Reserve System
before the
Senate Small Business Committee
February 5, 1975

I am pleased to appear before the Committee in its initial hearings of the 94th Congress to provide an overview of the impact of recession and inflation on small business. This is an important subject for the Committee to consider at the present time, since there is little reason to believe that small businesses have been spared the effects of the current recession and our underlying inflation.

I shall not attempt to suggest specific public policies particularly applicable to the difficulties of small businesses in coping with these two problems. Other witnesses you have invited are more knowledgeable in these matters. I shall instead direct my remarks primarily to the over-all economic situation, as I and my colleagues on the Board see it, and to the general public policies which we consider essential to the reattainment of a prosperous, expanding economy. That kind of economy, of course, provides the environment in which small business is able to thrive.

The goal of fiscal and monetary policy must continue to involve control of inflationary forces. That objective need not be compromised by fiscal and monetary stimuli which properly used can slow and contribute to a reversal of recessionary forces. However, these stimuli, if they are to eventuate in sustained growth in economic activity, must not give rise to widespread apprehension among consumers

and businessmen that inflation will persist because of the vigor or character of countercyclical actions.

The country is now experiencing a significantly reduced level of business activity. Production has declined about as sharply in recent months as at any time since World War II. The unemployment rate has increased to over 8 per cent. Despite the cutbacks in production, weakness in sales has caused inventories to pile up. Consumer demand has been particularly weak in markets that are important to small business--new homes, furniture and other household furnishing, clothing, autos. Moreover, the additions to productive capacity which are essential for providing increased employment and personal income are being jeopardized by the postponement and cancellation of capital expenditure programs.

Some further decline in economic activity may occur over the near term, given the weakness in demand in so many sectors and the need for business to continue working off excess inventories. While there is some evidence, as in the auto industry, that a foundation is being laid for an upturn in activity, a broadly based recovery may not get under way until consumers and businesses can see progress being made in halting the persistent rise in prices and resulting erosion in personal and business incomes.

The slower rise in average consumer prices in recent months, and the decline in average wholesale prices in December and January, are encouraging developments. But it is too early to conclude that inflation is now under control. The fact remains that, during 1974

as a whole, the index of consumer prices increased by 12 per cent and the wholesale price index by 21 per cent, following increases of 9 per cent and 18 per cent during 1973. Underlying inflationary forces, and expectations of further inflation, have become entrenched and we need a period of relative price stability to dislodge them.

The inflation that is proving so troublesome has been accelerating in other industrialized countries. Both here and abroad, the pace of economic activity soon began to look less robust, and recessionary problems are now common to many countries.

In this country, consumer markets---especially for autos, furniture, and household appliances--began to weaken as early as the spring of 1973, as the real value of people's earnings and savings declined and confidence waned. Demands for credit increased sharply and interest rates rose dramatically. The search for higher returns pulled funds out of the thrift institutions and the resulting shortage of mortgage credit, combined with rising construction costs and weakened consumer demand, depressed the housing industry.

Despite the spread of weakness in consumer markets, the business community did not reduce its level of operations for some time. We have no way of knowing why this was so. The reason may have varied from industry to industry and from company to company. It may have been because of continued or expected shortages in critical materials; or because the weakening in final demands was not regarded as more than a temporary aberration; or because the rapid rise in prices following termination of controls encouraged some companies to

accelerate their ordering; or because the rise in nominal sales and profits masked both the decline in the real volume of sales and profits and the rise in the relation of physical inventories to real sales.

Regardless of why it happened, the delay in matching output to final demands permitted imbalances to build up and increased the severity of the decline in employment and production which began in October of last year.

In part because of the slowdown in economic activity, conditions in financial markets are easier now than they were last summer. Interest rates--especially short-term rates--have declined by a third to a half from mid-1974 highs and are still trending downward. Rates charged on small-sized business loans appear to have come down less than rates available to large borrowers, but they also had not risen by as much. With the decline in market rates, banks and specialized mortgage lenders are again receiving savings inflows, the liquidity of financial institutions is improving rapidly, and more funds are available for mortgage and other lending.

Public policy must now cope with a recession which needs a stimulus to private demands and an engine of inflation which must not be restarted. Under present circumstances, a temporary reduction in income taxes would seem an appropriate stimulus to private spending. Many individuals and unincorporated businesses, whose real incomes may have declined, are now taxed at higher rates because their nominal incomes have been increased by inflation. Ordinarily, nominal incomes are more likely to decline in a recession and the accompanying decline

in tax liabilities provides one of the automatic stabilizers which help to moderate recessionary impacts. Inflation has also increased the tax burden on the real incomes of corporate businesses because so much of the increase in nominal profits reflects the undercosting of capital goods and inventories used up in production and is thus illusory.

several Tax cuts to provide a temporary lift to private demand should not add to Federal deficits over the longer run. The President's proposals for a tax rebate to individuals and an increased investment tax credit for businesses meet this test. At the same time, as the President's fiscal program recognizes, the near-term inflationary effects of these stimuli need to be minimized by restraining Federal expenditures.

Given this environment of declining interest rates, larger flows of loanable funds, lessening rates of wholesale and consumer price rise, and tax refunds to stimulate the economy, most business analysts are projecting an upturn in business activity in the second half of the year. Thus, the climate forecasted for small business investment in terms of the underlying economic factors appears to be better than it has been for some time. The cloud on this horizon, if there is one, is the apprehension of lenders who, having experienced numerous work-out situations for borrowers within the past year, may be disposed to impose credit standards which many small enterprises could have difficulty in meeting.

incomes have been increased