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Statement of

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Chairman, Board of Governors of the Federal Reserve System,

before the

Ways and Means Committee

of the

House of Representatives

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Thank you for this opportunity of appearing before your Committee to urge prompt enactment by the Congress of the tax program recommended by the President. I might note that all Members of the Board concur in this view.

Prudent management of the Government's finances and the economy's welfare calls for restraint in private and public spending in the months ahead, if the vigorous economic expansion now underway is to be sustained without accentuating inflationary pressures. In the absence of the proposed program to reduce expenditures and increase taxes, the Federal deficit for this fiscal year could be the largest since World War II. The stimulus to the economy resulting from such a deficit is simply not warranted by the current and prospective economic situation; indeed, it would be highly damaging to the national objectives of achieving maximum sustainable growth and moving toward equilibrium in our international balance of payments. While deficits may at times be an unavoidable outcome of fiscal efforts to combat recessions, perpetual deficits--in good times as well as bad--can only undermine the world's confidence in our currency and defeat our efforts to maintain a full employment economy.

There can be little doubt that the economy has resumed vigorous expansion. We have emerged from a temporary pause that, in terms of historical experience, was brief and mild. Within a six-month period, and with minimal effects on output and employment, our economy has been able to shake off the effects of a marked reduction in consumer willingness to spend and a massive effort by businesses to reduce excessive inventory investment. Last December, business inventories were rising at a $20 billion annual rate; by June inventories were falling at a $3 billion annual rate. Yet even with such a major inventory adjustment depressing demands for further production, the drop in industrial output was limited to about 2 per cent, and unemployment never exceeded the 4 per cent level--a level close to our full employment target. This remarkable performance testifies to the fundamental resiliency and strength of our economy, as well as to the efficacy of flexible fiscal and monetary policies.

For its part, monetary policy, which had carried the brunt of the battle to restrain inflationary pressures in 1966, moved promptly toward a position of ease last fall, as soon as it became evident that inflationary pressures were coming under control. Ample reserves were made available to the banking system, and the banking system responded to monetary ease by rapidly expanding its loans and investments. Over the first half of this year, bank credit increased at a 12 per cent annual rate.

Beginning last fall, the cost of borrowed funds dropped sharply. For example, the rate on 3-month Treasury bills dropped by 3/4 of a percentage point between September 1966 and the end of that year, and continued to decline by another full percentage point through the winter and the spring of 1967, as the Federal Reserve continued to pursue a stimulative policy.

Long-term interest rates also declined significantly last fall and early this winter. However, the cost of long-term financing in bond markets turned up some months ago, under the pressure of a record volume of security offerings. Corporations had drawn heavily on their liquid assets and lines of credit last year in financing the boom in capital goods expenditures during a period of monetary restraint. With a return to conditions of monetary ease, corporations attempted to restore liquidity, principally by lengthening the maturity of their debts. Moreover, as the size of the potential Federal deficit became clearer and fears of inflation revived, market participants hastened to borrow available loan funds at the longest maturities possible. As one result, an unusually large proportion of corporate financing this year has taken the form of long-term security issues, particularly public offerings of bonds. The volume of bond flotations has exceeded that of any prior period by a sizable margin.

Despite the consequent rise in the yields available on corporate bonds, the flow of savings into depositary institutions has continued to mount rapidly. In the first six months of the year, net flows into mutual savings banks and savings and loan associations, and into time and savings deposits at commercial banks, reached record levels. Large inflows have continued this summer, reaching record growth at mutual savings banks in July, and the largest July inflow in eight years for savings and loan associations. In turn, these institutions have been able to provide a greatly enlarged volume of funds for the financing of residential construction. By the second quarter of the year, mortgage debt was expanding at an annual rate of $20 billion, up a third from the rate of increase in fourth quarter of last year. And outstanding commitments for future mortgage lending by the major institutional suppliers of such funds were nearly one-third larger in July than at the beginning of 1967.

Accompanying monetary ease was a strongly stimulative fiscal policy. Government expenditures, spurred by rising defense outlays, increased rapidly. Furthermore, some of the Government funds impounded in the fall of 1966 to reduce inflationary pressures were released, and tax incentives to encourage business investment in new equipment were reinstated. The Federal deficit increased on the basis of all three methods of budget-keeping. As measured by the national income accounts budget, the deficit increased from a $3 billion annual rate in the final quarter of 1966 to almost $15 billion in the spring of this year.

The economy's response to monetary and fiscal stimulation is apparent in the current flood of statistics showing resumption of vigorous expansion. Retail sales have been rising strongly since spring; gains in personal incomes in June and July were more than double the average in earlier months of the year; industrial production rebounded in July and preliminary data indicate another rise in August; manufacturers' order backlogs have continued to edge up. Business efforts to reduce inventories appear to have ended; indeed, some inventory rebuilding by manufacturers began in July. Further, housing construction is moving up sharply; labor markets have strengthened, and unemployment is drifting down.

Though most measures of economic activity are registering significant gains, there are--as is usually the case--some exceptions. For example, new orders received by manufacturers dipped in July, following five consecutive months of increase. And a recent survey suggests that the increase in business spending for new plant and equipment over the balance of the year will probably be somewhat smaller than had been forecast by businessmen earlier in the year. But our assessment of the current economic situation is that the strengths far outweigh any weakness, and that, over-all, the economy is moving on a course of rapid expansion.

Along with the welcome evidence of economic resurgence, however, have come disturbing indications of renewed inflationary pressure. Recently, the rise in the cost of living has accelerated. Since spring, the consumers price index has increased at an annual rate of over 4 per cent, compared with less than 1 per cent during the winter. And after an extended period of stability, industrial prices are moving up again under the pressure of rising demand and costs. Increases have been noted for a number of key industrial materials--copper, steel, lumber, other building materials, crude oil--and for a variety of manufactured products: tires, carpets, television sets, appliances, metal working machinery. With markets more buoyant, the costs of materials rising, and labor costs up sharply--unit labor costs rose 5½ per cent from mid-1966 to mid-1967--the incentives and the opportunities to raise prices have been increased.

Distinctions sometimes made between cost-push and demand-pull inflation should not be allowed to obscure the fact that both types feed on each other. The rise in wage costs that gets translated into higher prices feeds back into higher wage demands as price pressures pervade the economy. For a time, the individual firm may feel it is escaping the consequences of acceding to wage increases greater than gains in productivity by passing on the higher costs to its customers. But in time, it too becomes a customer, and finds a higher materials bill added to its higher wage costs. In the end, inflation hits all. The purpose of economic policy must be to see that demand does not exceed the limits of our resources, and so to make it unlikely that higher prices can be passed through effectively, from one business to another and on to the public at large. In the absence of restraint, excessive demands will appear to validate excessive cost increases and, in the process, encourage even further price rises.

The task for public policy in the months ahead, then, will be to maintain vigorous growth without exceeding the bounds of available resources. Even a cautious appraisal of the future indicates the difficulty of this task. The surge in private spending promises to continue in most sectors of the economy. Consumer spending, which has displayed strength in recent months, will undoubtedly continue to rise as incomes advance rapidly. Indeed, consumers are likely to spend an increasing proportion of their growing incomes, and to finance expenditures on credit more freely.

Businesses appear to have achieved a more satisfactory balance between stocks and sales, and the greater likelihood--barring prolonged strikes--is for some modest rebuilding of stocks in the months ahead. The abundance of funds flowing into thrift institutions is being reflected in a sharp rise in new home construction, and the large volume of funds committed for the future to finance this activity should permit a continued rapid increase in home building. Business investment is not likely to resume the frenzied pace of 1965 and 1966, but the restoration of tax incentives for these outlays, along with expanding retail markets, should at least sustain business expenditures for new plant and equipment at present high levels.

The auto strike may for a time mask the underlying strength of expansive forces in the economy, but in the past, termination of such strikes has been followed by surges in auto production and sales. And there have already been announcements of price increases for autos, based in part on cost increases anticipated to result from new labor contracts. Thus, looking beyond the strike, expansion in economic activity can be expected to be rapid, and upward pressure on costs and prices to continue, and perhaps to accelerate.

Added to rising private expenditures will be military outlays substantially above the level predicted last January. As Secretary Fowler and Budget Director Schultze have already indicated to this Committee, the additional resources to be committed to Vietnam this fiscal year could raise Government spending for defense purposes by $4 billion above earlier estimates, to a level some $10 billion higher than such outlays were in fiscal year 1967. And Federal spending outside the defense area might also turn out to be higher than projected in last January's Budget, despite Administration and Congressional efforts to reduce them.

In total, prospective private and public demands appear likely to outstrip the ability to accommodate them at reasonably stable prices. Private demands could become accelerated further if expectations of inflation spread: modest inventory rebuilding could turn into a scramble for goods; the contemplated industrial plant or office building, deferred on today's prospects, could suddenly become undeferrable if construction costs begin to spiral. Further rise in consumer prices could trigger higher wage demands. And the willingness of investors to acquire fixed-income, longer-maturity securities--mortgages, municipal bonds, Treasury issues--would be eroded.

Our strong and prosperous economy can afford to undertake--and to pay for--many burdens. But it cannot afford inflation. Our domestic objective of sustained economic growth cannot be achieved if prospects of inflation lead to unwise private decisions--with respect to inventories, or industrial capacity, or credit--decisions reversible only at great cost both to the individual enterprise and to society generally. The interruption to economic growth in the first quarter of this year can be traced to the excessive accumulation of inventories last year, an accumulation inspired partly by fear that to delay buying would mean paying more later. Unless the business community and the consuming public have confidence that the Government will display the courage and wisdom to prevent inflation, we will be doomed to a dreary cycle of spurts and stops in activity, and to distortions in the structure of production, rather than to sustained and balanced growth.

Certainly we cannot afford the effects of inflation on our balance of payments. Basic to a restoration of equilibrium in our international payments is an improvement in our trade position. This requires that the prices of our products be competitive in world markets, and that we avoid excessive demands at home which induce too large an inflow of imported goods. The experience in 1965 and 1966, when imports moved up much faster than growth in our economy as a whole, demonstrated how quickly our trade position can deteriorate. We must maintain conditions that will avoid such excessive surges in imports, and that will promote a vigorous growth of exports. And increasing our exports is made more difficult than usual, at the moment, by the slack economic situation now prevailing in several of our major export markets. Under these conditions, advances in our price level here would quickly endanger the modest improvement in our trading balance we have managed to achieve thus far this year.

Thus, maintenance of our domestic health and our international solvency both depend importantly on the ability to contain cost and price pressures in a full employment economy. The President's fiscal program, which would defer less essential Federal spending and would moderate the expansion of private spending by a temporary increase in income taxes, is essential if we are to bring aggregate demands into balance with available resources. And it is essential to implement this program promptly, for delay is permitting inflationary forces to gain momentum and enhancing uncertainties in financial markets. Financial markets cannot be insulated from the laws of supply and demand; market participants realize that a Federal deficit of record proportions on top of the loan demands generated by a booming private economy would add up to overall demands for credit far beyond the savings capacity of the economy. The resultant pressures in financial markets would necessarily be reflected in rising costs of credit, even with continued generous provision of reserves to the banking system.

Inasmuch as long-term interest rates for corporate and municipal borrowers have already moved up, partly in fear of over-reliance by the Government on monetary restraint, confirmation of that fear could stimulate a scramble for funds that would drive interest rates to unprecedented levels. The major institutions financing the housing industry, whose ability to compete for savings is limited both by the structure of their portfolios and by regulation, would once more find their inflows of funds curtailed and be unable to sustain the growth in home construction. Rigidities and imperfections in our financial structure, which channeled so much of the burden of monetary restraint onto the housing sector in 1966, have not yet been remedied, and there is no reason to think that the same unfortunate consequence would not again result from over-reliance on one tool of stabilization policy. It would be unjust, as well as unwise economically, to put so much of the burden of restraint on the housing industry again. We are fighting a war, and we should not expect one sector of the economy to bear a disproportionate share of the cost.

Of course none of us can foresee the future with certainty. But in my judgment a tax increase is needed to avoid consequences that would be even more unpleasant. Today these troubles can be seen developing. If tomorrow they have come to pass, the opportunity to move against them will be gone. It seems to me that we have already clear and compelling evidence of a resurgence in inflationary pressures which, if unchecked, would curtail our domestic expansion, aggravate an already serious balance of payments problem, and bring severe strains in the markets for credit, particularly the mortgage market. In my opinion, it would be grossly imprudent not to take timely action against these dangers. Accordingly, I favor prompt enactment of the tax program proposed by the President.

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