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Statement of
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before the
Ways and Means Committee
of the
House of Representatives

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It is less than eight weeks since I last had the opportunity to discuss with this Committee the economic and financial conditions of the country, but these have been eventful weeks indeed. Production, employment and incomes have all surged to new peaks, and unemployment has fallen sharply. With the retarding effects of major strikes largely behind us, the fundamental strength of expansionary forces in the economy has been more clearly revealed.

But, unfortunately, the surge in domestic activity has been accompanied by a further rapid advance in prices. And, unfortunately, these developments in domestic activity and prices have been accompanied by a serious deterioration in our international payments balance, necessitating the mounting of a new and more stringent program for temporary restriction of capital outflows and other expenditures abroad.

As the President stated, in his balance of payments message, "The first line of defense of the dollar is the strength of the American economy." That strength is now being sapped by inflation. For the second quarter in a row, nearly half of the rise in our gross national product has reflected inflated prices rather than real growth. Prices have risen at wholesale and retail, for farm products as well as for industrial commodities. Moreover, the pace of the increase has been accelerating. The rise in the price component of the GNP, which had slowed to about a 2 per cent rate last spring, was advancing at a rate of over 4 per cent in the final quarter of the year.

It is clear from the experience of 1966 and 1967--and indeed, from many other periods in our history--that we cannot achieve sustained economic growth under conditions of inflation. The distortions that inflation induces in the structure of output and demands, and the pressures it generates in financial markets, inevitably result in economic dislocation. Inflation in 1966 was followed by a cessation of growth in early 1967; a more severe adjustment was averted only by the prompt and flexible use of monetary and fiscal policies. Nevertheless, there was a penalty to pay--in the form of lost production and employment--for the failure to act early enough the preceding year in containing the emergence of excessive demand pressures.

We are now seeing some of these distortions and pressures developing again. Businessmen have already begun to step up their accumulation of inventories, in part to "beat the price rise." Negotiators of new wage contracts have built last year's price rise into next year's wage costs. But consumers have reacted to swiftly rising prices by spending more cautiously.

The increase in business ordering and inventory accumulation has been reflected in a faster pace of business borrowing at banks, accompanied by a reduced flow of banking funds into securities. In financial markets, the high levels of yields on market securities has begun to curtail the availability of funds for the financing of home construction, both by reducing the inflows of consumer savings to institutions specializing in home finance, and by diverting funds from mortgages to other types of investment at institutions that normally

do a substantial mortgage loan business. Repeating the by-now familiar cycle, growth in commitments for mortgage lending is being curtailed, and mortgage yields have already risen back to the peaks of 1966.

The pressures that developed in financial markets over the summer and fall of 1967 reflected not only the normal rise in private demands for funds that accompanies resurgence in economic activity, but also the extraordinary additional demands arising from the Federal Government's deficit. Borrowing by the Treasury in the second half of last year was more than double that of the preceding year; the Government accounted for more than a quarter of all the funds raised in credit and equity markets between June and December, compared with less than a tenth in the comparable period of 1966.

The reaction of other borrowers to this enormous volume of Treasury financing, and to the possibility of continued preemption of loanable funds by the Government, was a flood of corporate and municipal security issues last summer and fall. The combined pressures of Federal and private credit demands resulted in a rise in interest rates that, by December, brought most long-term borrowing costs to levels well above those reached at the height of the credit strain in 1966.

Pressures in financial markets have abated somewhat in recent weeks, partly as a result of seasonal factors, partly in response to peace rumors, and partly because of revived hopes for greater fiscal restraint. But in the absence of such restraint, the Government's financing needs will again press on financial markets.

Without the added revenues from the proposed surcharge, the Treasury will have to borrow a substantial volume of funds this winter and spring, a period of the year when it usually has been a net supplier of funds to the market. Moreover, the prospects of continued large Treasury financing, and the attendant prospects of continued and--perhaps accelerating--inflation, would undoubtedly stimulate a renewal of large private financing demands.

If these developments result in renewed and stronger tensions in financial markets, housing finance would undoubtedly suffer again, better insulated though it may be from a repetition of the sharp contraction in 1966. As I commented to this Committee last September, it is neither socially justifiable nor economically sound to put so much of the burden of financing a war on one sector of the economy.

Distortion in the domestic economy is only one of the risks we face if excessive demand pressures remain unchecked. We need to combat inflation not only to prevent erosion of the value of the dollar domestically but also to maintain its value internationally.

Our merchandise trade balance has already been sharply reduced. It would serve for naught for us to curb international outflows on capital account through temporary restrictions, but at the same time lose the battle to improve the long-run strength of our balance of payments stemming from the competitiveness of U. S. products in world markets. The ability of a country to compete energetically and successfully in international markets is widely recognized as one

of the firmest indications of the strength of a currency. Correspondingly, a country whose international trade position is weak and seems to be deteriorating may find its currency subject to speculative attacks.

Changes in the competitive position in international trade of an industrial country occur gradually over time. But once lost, a strong competitive position is difficult to regain. It would be a poor bargain to improve our over-all payments position temporarily through stringent curbs on capital outflows, while neglecting to take the steps necessary to assure the long-run strength of that position. That strength depends in large measure on curbing the inflationary cost and price increases that would make it increasingly difficult for our exports to compete in world markets and for our domestically produced goods to compete with imports.

The surest way to surmount this threat is through restraint on public and private spending, the goals of the fiscal program that the President has put before you. By reducing to a minimum the risk of continued inflation, we would demonstrate to the world the high priority we give to maintenance of the competitive position of the United States dollar. Even more important, we would thereby lay the basis for a balanced and sustainable rate of real economic growth that is, in the end, the true source of confidence in our currency, at home and abroad.