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Statement by

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before the

Committee on Banking and Currency

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I am pleased to appear before this Committee today to discuss with you recent developments in financial markets and especially the trend of interest rates over the past several years. I have frequently testified that I would like to see interest rates as low as we can have them without inflation. And I would add now that the way to get interest rates down is to end the inflation that has been raising them.

Let me set forth a few of my own ideas as to why interest rates have risen to the present unprecedented levels, and what must be done if we are to see a return to a level of interest rates consistent with satisfactory rates of investment over the long run in such areas as housing and plant and equipment.

To begin with, the current period of high interest rates needs to be viewed in the longer-run perspective of interest rate trends over the period since World War II. While there have been short-run swings in interest rates over these past two decades, in response to variations in the tempo of economic activity, several major factors have contributed to the persistent upward trend that we have experienced.

The most important contributing factor has been the extraordinarily high rate of technological progress occurring both in the U.S. and abroad. It scarcely seems possible that twenty years ago television sets, synthetic fibers, and plastic containers were products that existed largely in the minds of engineers and chemists, or that

the use of computers and the automation of production processes were just beginning to affect business thinking and planning. As Apollo 8 was circling the moon, I was reminded that the first manned flight of any kind took place only a little more than 60 years ago. And much of the progress symbolized by that leap forward has occurred during the past three decades.

The technological discoveries of this period have required extraordinarily large investments to be incorporated into new products and processes, and this, of course, has meant heavy demands for financing. Earlier in the postwar period, businesses were able to draw heavily on internally generated funds and on stocks of liquid assets built up during World War II to help finance these projects. As the postwar period proceeded, however, they had to rely increasingly on external sources to meet financing needs.

High rates of investment are, as we are all aware, a principal source of gains in productivity, in real income, and in our standards of living. Rarely has any society been as fortunate as ours in realizing the benefits of almost continuous economic prosperity over the past twenty years. Per capita disposable income in the U.S., in real terms, is fully 50 per cent higher now than it was at the end of World War II. And our consuming public has chosen to enjoy the fruits of material progress in ways that put heavy demands on the credit markets. Consumers have demanded more and better homes, and a wider and more varied stock of durable goods.

To purchase these assets, consumers depend significantly on mortgage and instalment credit.

Another factor in the long upward trend of interest rates in the postwar years has been the major change that has occurred in asset portfolios of financial investors. Both institutional and other investors entered the postwar period with exceptionally large holdings of liquid assets, accumulated largely as a result of wartime deficit spending. Consequently, even though interest rates were at exceptionally low levels, investors were anxious to switch from liquid assets into mortgages, consumer loans, and corporate and municipal securities. The abundance of available loan funds held interest rates down in the first postwar decade, but as the backlog of liquidity was worked off, greater interest rate incentives were required to encourage investors to supply funds to finance economic expansion.

As the postwar years unfolded, investors also began to show heightened preferences for equity investments as contrasted with fixed-income securities. To some degree, this reflected the failure to follow stabilization policies that might have kept inflation under better control. But it also resulted from the degree of success we did enjoy in avoiding the deep declines in economic activity that occurred prior to World War II.

To an important degree, then, the general upward trend in postwar interest rates has been symptomatic of the vigor of economic expansion. Yet, it seems quite clear to me that even in prosperous

times we can have lower and relatively more stable interest rates than prevail today. We enjoyed interest rate developments of that kind during the early years of the 1960's. Indeed, interest rates on some kinds of financial assets, such as mortgages, declined a little over the first five years of the present decade. But beginning about the middle of 1965, the cost of credit began to rise, and we are still seeing increases going on today. What accounts for this abrupt change in the demand--supply equation in financial markets during the past 3-1/2 years?

The answer to that question is not, I think, hard to discover. Since mid 1965, except for a brief respite in early 1967, we have had an overheated economy and growing expectations of inflation. Private spending decisions have been influenced in fundamental ways. We received word just recently that businesses are planning to raise their expenditures for plant and equipment by 14 per cent in 1969 over the 1968 level. While the size of the anticipated growth in capital outlays was larger than many observers had expected, the news that plans for the period ahead were strong should not have come as a great surprise. With wages increasing at rates well beyond the growth of productivity, with costs of capital goods rising, and with expectations developed over the past several years that higher costs can sooner or later be passed on in the form of higher prices, why shouldn't we expect businesses to do what they can to introduce cost-cutting methods and to put new capacity in place at today's prices?

This recent announcement of upward revisions in business investment plans for 1969 is a continuation of developments that became evident around the middle of last year, when the rate of business investment began to strengthen measurably, despite the fact that rates of capacity utilization in manufacturing were not especially high, and stern measures of fiscal restraint had just been adopted. We also experienced a large rise in housing starts in the latter half of last year, even though interest rates on mortgages were at record levels--and rising--while flows of funds through traditional sources of mortgage finance were falling off.

Let us consider for a moment the cost-price developments that businesses and consumers have had to take into account in making their investment decisions. From the middle of 1965 to the end of 1968, consumer prices rose at an annual rate of 3-1/2 per cent, compared with a 1-1/2 per cent annual rate in the previous 3-1/2 years; for wholesale prices, the figures are 2 per cent for the recent period, and three-fourths of one per cent for the prior 3-1/2 years; for construction costs, 4-1/2 per cent and 2 per cent; for average hourly compensation in manufacturing, 5-1/2 per cent compared with 3-3/4 per cent, and for unit labor costs in manufacturing, 4 per cent in the past 3-1/2 years compared with no change in the prior 3-1/2 years. Is it any wonder that consumers want to buy houses now to avoid paying higher prices later? Should we be surprised that businesses are trying to find some method of holding down the rise in production costs and are searching for labor-saving investments as a means to do so?

Financing the high level of private investment has increased greatly the demands on money and capital markets. From 1960 to 1964, nonfinancial businesses and consumers together borrowed new funds at an average rate of about \$38 billion a year. Since 1965, the annual average has been \$59 billion--or more than 50 per cent higher--and in 1968 the figure rose to \$67 billion. In the past 3 years nonfinancial corporations raised new capital through bond issues in amounts averaging nearly \$13 billion a year, about 3 times as much as during the previous three years.

In addition to this large demand for private credit, pressures in credit markets have reflected heavy Federal borrowing, resulting from our failure to adopt earlier the measures of fiscal restraint needed to avoid deficit financing and inflationary pressures. In calendar 1966, Federal financing requirements remained relatively modest, even though expenditures rose substantially, since revenues also increased rapidly with growth in private money incomes. Consequently, total Federal borrowing, including the issues of some Government agencies and enterprises that have recently been shifted to private ownership, was held to \$6 billion in 1966. But in 1967, the comparable figure rose to \$13 billion, and then to \$17 billion in 1968. In recent months, the borrowing needs of the Federal Government have slackened appreciably, as the budget has moved into surplus in response to the measures of fiscal restraint enacted last summer.

It seems abundantly clear that interest rates would be still higher today if those fiscal actions had not been taken.

It seems to me as I look back over these past several years, therefore, that the major factors forcing up interest rates stand out quite clearly. What we have seen is a rising tide of inflationary pressure, fed in part by Federal deficit spending, generating in turn widespread expectations of more inflation to come, mounting private demands for credit to finance additional spending, and hence increased costs of funds. Developments comparable to these have occurred in many other countries, and we have recognized them for what they were. But it sometimes seems hard for us to recognize that the fundamental economic principles of supply and demand apply to us--no matter how vast and well-endowed our country is--as well as to others.

I want to note quite specifically that the runup in interest rates since the middle of 1965 does not stem principally from diminution in the supply of credit created by restrictive monetary policies. Monetary policy has been restrictive during some intervals over the past several years--from late 1965 to the fall of 1966, for a brief period in the late spring of 1968, and then again from late 1968 to the present. But in surrounding periods the supply of money and credit grew rapidly, and the period 1965-68 as a whole was one of rather substantial monetary expansion. Let me again cite some statistics,

In the four years 1965 through 1968, total member bank reserves rose at an average annual rate of 6 per cent; in the prior 4 years the average annual increase was 4 per cent. From 1965 through 1968, total commercial bank credit rose at a 9-1/2 per cent annual rate, compared with 8 per cent for the previous four years. For the stock of money (currency and demand deposits) the annual average rate of gain was 5 per cent for 1965-68 versus 3 per cent for 1961-64.

I do not think the degree of monetary restraint or ease can be summarized very precisely in any single set of numbers such as these. But it would seem reasonable to conclude from these data that the rise in interest rates over the past several years did not result from a reduction in credit supplies, but from an exceptional rise in credit demands.

I do not mean to argue that the interest rate developments of recent years have had no relation to monetary policy. We know that, in the short-run, expansive monetary policies tend to reduce interest rates and restrictive monetary policies to raise them. But in the long-run, in a full-employment economy, expansive monetary policies foster greater inflation, and encourage borrowers to make even larger demands on the credit markets, while lenders pull back from taking positions in fixed-income securities--since they fear that both interest and principal will be eroded by rising prices.

Over the long-run, therefore, expansive monetary policies may not lower interest rates; in fact, they may raise them appreciably. This is the clear lesson of history that has been reconfirmed by the experience of the past several years.

If my diagnosis of our current interest rate problem is correct, then it is clear what we need to do to get interest rates back down to more sensible levels. We must follow economic stabilization policies that bring inflation under control, and continue those policies long enough to be sure that a resurgence of excess demand and strong cost and price pressures does not recur.

I think we have made a good beginning in the adoption of stabilization policies that will eventually accomplish those objectives. Last year the Congress adopted fiscal restraint measures that altered the Federal budgetary position dramatically. As a consequence, we can look forward to surpluses in the Federal budget, as measured in the national income and product accounts, at an annual rate of around \$5 billion during the first half of this year. A year earlier, the budget--figured on the same basis--was in deficit to the tune of roughly \$10 billion, at annual rates.

The fiscal measures enacted last summer took hold a little later than we had expected, and hoped for, but these measures are becoming effective. Nonetheless, we have some distance to go yet in cooling off the economy. There now seems to be little, if any, hope that we can ease up on fiscal restraint in the near future; the

strength of expansionary forces is still much too great for that. The surtax will almost certainly have to be continued after midyear, in my judgment. Indeed, the real question now is whether fiscal policy should move another notch in the restrictive direction, given the possibility that we may be facing a strong capital goods boom.

The start we have made in adapting stabilization policies to the needs of the economy also includes a marked change in the posture of monetary policy since late last year. Monetary policies generally work with a significant lag, in terms of their effects on spending and on prices, partly because it takes time to work off excess liquidity in the economy. Nonetheless, the effects of monetary actions show up much earlier in financial markets than they do in markets for goods and services.

The data in the table attached to the end of my statement provide some indication of the financial effects of the more restrictive policies in effect since late last year. The annual growth rate of the money stock has been reduced from about 7-1/2 per cent in the fourth quarter of last year to about 2 per cent in the first three months of 1969. For time deposits, the turnaround has been much greater, since outstanding CD's at large banks have declined about \$3-1/2 to \$4 billion since the beginning of the year. As a result, total bank credit (as measured by what we call the credit proxy, adjusted to include increased Eurodollar borrowing abroad by our banks) will show a small decline in the first quarter, a marked

change from the nearly 12 per cent annual rate of growth experienced in the final three months of last year.

I am confident that interest rates will turn down again just as soon as it becomes abundantly clear to everyone that the fiscal and monetary authorities have no intention of letting inflation proceed, and borrowing and spending decisions are adjusted accordingly. What I have called the challenge of "disinflation without deflation" can be met most effectively if lenders and borrowers will now exercise the utmost restraint in taking on new commitments. A sincere effort at such self-restraint will, I believe, prove to be in the best long-run interest of the individual firms themselves as well as of the communities and nation which they serve. Continued, unchecked inflation can be an insidiouscrippler of much of the best in the American system. I think it behooves all of us to stand resolutely against that threat.

I am reasonably confident that we are on the road to accomplishing the objectives for which we are striving. We will be seeing, as the year progresses, the results of monetary and fiscal policies working together to restrain inflation for the first time in a number of years.

Attachment

SELECTED MONETARY AND FINANCIAL INDICATORS
March 24, 1969

Quantities	Annual percentage rates of change		
	4th quarter 1968	Jan.-Feb. 1969	1st quarter 1969 (Proj.)
1. Total reserves	8.8	4.5	0.8
2. Nonborrowed reserves	3.0	5.0	1.5
3. Money supply (currency & private demand deposits)	7.6	2.2	1.7
4. Time and savings deposits at banks	15.7	-9.7	-6.7
5. Money supply plus time deposits (3+4)	11.8	-3.9	-2.5
6. Total member bank deposits-- credit proxy	12.2	-3.0	-4.7
7. Proxy including Eurodollars	11.7	-- <u>2</u> /	-1.7
8. Deposits at savings banks and S&Ls	6.5	5.2	n.a.

Interest Rates	Percentage annual yield (weekly averages <u>1</u> /)		
	Dec. 1968 high	Jan. 1969 low	Most recent week
FR discount rate	5.50	5.50	5.50
Federal funds	6.25	6.27	6.82
3 mo. Treasury bills	6.21	6.07	6.02
3 mo. Federal Agencies	6.38	6.34	6.35
3 mo. Finance company paper	5.88	6.08	6.38
3 mo. Euro-dollars	7.33	7.31	8.51
Long Gov't bonds	6.04	5.95	6.29
Municipal bonds	4.85	4.82	5.29
Aaa Corporates-new issues	6.92	6.90	7.57
FHA mortgages (FNMA auction gross yields)	7.65	7.66	8.08

n.a. - Not available.

1/ All interest rates are weekly averages except for 3-month Federal Agencies, municipal bonds, Aaa corporate new issues, and FHA mortgages which are single date figures.

2/ Less than \$50 million.