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Statement by

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before the

Committee on Banking, Finance, and Urban Affairs

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I am pleased to appear before this Committee once again to present the report of the Federal Reserve Board on the condition of the national economy and the course of monetary policy.

Since the closing months of 1976, our Nation has experienced a vigorous and broadly based economic expansion. The gains in the industrial sector have been especially impressive; during the past 8 months, the combined output of factories, mines, and power plants has risen at an annual rate of 9-1/2 per cent. Activity in other sectors of the economy also has increased briskly. As a result, total employment in June was almost 3 million higher than last October -- an unprecedented gain in so short a period. The unemployment rate remains high; but it has declined in recent months by nearly a full percentage point, despite rapid growth of the labor force. The rate of utilization of our industrial plant capacity also has risen significantly, and now exceeds 83 per cent in manufacturing.

Demand for consumer goods has continued to propel the expansion. With confidence buoyed by improving economic conditions, consumers have been spending freely from current income besides adding significantly to their personal indebtedness.

The strong buying mood of consumers is reflected in the personal saving rate, which in the first half of this year averaged less than at any time since the early 1960's.

Retail sales climbed steeply during the fall and winter months and remained at a high level this spring. Over the past three quarters, retail sales, after adjustment for price increases, have risen at an annual rate of about 6 per cent. Auto sales contributed greatly to the advance, averaging -- on a seasonally adjusted basis -- almost one million cars per month since March.

The rise of consumer spending played a major role in prompting a resurgence of inventory investment early this year. A moderate inventory correction in the latter part of 1976 had reduced the ratio of stocks to sales to exceptionally low levels in many lines of trade and manufacturing. Once sales again accelerated, businessmen had to rebuild their inventories in order to meet customer demands. The annual rate of additions to business inventories reached $14 billion in the first quarter of this year, and perhaps $20 billion in the quarter just ended.

In the past two months or so, it appears that stocks in certain categories of nondurable goods reached somewhat higher levels than businessmen desired. The latest data on employment and production in manufacturing suggest that business firms have again moved promptly to reverse the build-up. With inventory positions generally still lean and sales prospects favorable, inventory investment is likely to contribute to economic expansion later in the year and on into 1978.

The upward trend of sales and of capacity utilization has encouraged businessmen to enlarge their outlays for plant and equipment. There are some signs that business capital spending may finally be gaining significant upward momentum. Order backlogs of capital goods manufacturers have been climbing. Business equipment posted the largest advance of any major category of industrial production during the first half. New contracts and orders for plant and equipment most recently have been running more than 20 per cent above year-earlier levels. To date, business capital expenditures have been concentrated largely on vehicles and other light equipment, but there is some tentative evidence that large construction projects and heavy machinery are beginning to make a contribution to the capital-goods recovery. All told, the evidence at hand points to moderate strength in spending on plant and equipment in the months ahead.

Residential construction meanwhile has remained a major area of strength in the economy. Home sales have been brisk, and the average level of single-family housing starts in the second quarter was the highest in more than two decades. The multi-family sector has continued to recover slowly, but the low vacancy rates in many localities are likely to stimulate additional construction. In certain parts of the country, especially in California, speculative activity in the single-family sector has recently emerged and this development bears watching. In general, however, the expansion of homebuilding seems to be realistically attuned to the Nation's mobile population. In the Board's judgment, residential construction will post further gains in coming quarters.

Governmental spending has picked up recently, most markedly in the State and local sector. The budgetary position of many State and local governments has improved considerably, being bolstered by Federal grants, by higher tax rates, and by the effects of economic expansion on tax revenues. State and local units have been able to expand employment more rapidly of late, although growth has not been as strong as in the 1960's and early 1970's. Their construction programs, delayed in many cases as governmental units concentrated on rebuilding their financial position, are moving ahead again and should provide significant impetus to economic activity in coming quarters.

The only major weak spot in the economy has been the foreign trade sector. Exports have been sluggish this year, being limited by the relatively slow economic expansion in other industrial nations. Most of these countries have experienced indecisive rebounds in business investment, and this has restricted the demand for American machinery -- an important part of our sales abroad.

Cyclical developments have also played a large role on the import side of the trade ledger. In general, the demand for imported industrial materials has increased in step with the recent rapid growth of production in this country. Imports of cyclically-sensitive durable goods -- such as machinery, autos, and other consumer items -- are also reflecting recent economic trends. And needless to say, oil imports have risen enormously this year, swelled first by cold weather and then by inventory building in anticipation of OPEC price increases.

Continuing advances in investment income and other nontrade items have partly offset the deficit in our foreign trade; even so, the current-account deficit has reached record size. Oil imports should experience some decline later this year, aided by the availability of Alaskan oil. But prevailing trends in economic activity here and abroad suggest little likelihood of significant near-term reduction in our foreign trade or current-account deficits.

In general, financial developments have favored economic expansion in our country, and they are continuing to do so. However, some familiar cyclical patterns have begun to emerge since the turn of the year.

Borrowing by households has been growing very rapidly. Instalment credit has expanded at a 16 per cent annual rate thus far this year. Measured relative to disposable personal income, growth of instalment credit has reached a pace comparable to past peak rates.

Mortgage credit flows have been of record magnitude. Mortgage credit has in fact grown much faster than could be expected on the basis of past relationships between borrowing and residential construction, thus suggesting that households have been putting mortgage funds to a broad variety of uses.

Despite the rapid growth of consumer and mortgage credit, measures of household debt burden generally remain within the range of historical experience. Moreover, delinquency and bankruptcy rates have declined significantly from their recession highs. At this juncture, debt burdens do not appear to constitute a serious impediment to further gains in household expenditures; but we must not overlook the possibility of excesses in this area.

Business firms also have placed heavy demands on credit markets this year. Their over-all need for external financing has grown because capital outlays have risen much faster than profits. The net funds raised by nonfinancial corporations increased by about 30 per cent between the second half of 1976 and the first half of this year.

The character of business borrowing has also shifted considerably. Until the latter part of 1976, business firms concentrated on repayment of short-term debt with the proceeds of long-term borrowing. Since last fall, long-term indebtedness has continued to grow, but not nearly so rapidly as short- and intermediate-term borrowing. Bank loans to businesses have increased at an annual rate of 11 per cent since last September, and commercial paper and finance company loans have increased even faster. These developments have caused liquidity ratios of corporate balance sheets to decline somewhat -- a normal cyclical development, although delayed in this case. Still, the state of corporate liquidity remains relatively comfortable because of the extensive improvement achieved during the preceding two years.

Credit demands by State and local governmental units have been very large this year. About a fifth of the record bond offerings has been devoted to advance refunding of debt issues that were sold in earlier years when interest rates were appreciably higher. The remainder has included substantial amounts to finance construction of public power plants, hospitals, and water and sewer facilities.

Federal Government borrowing, in contrast, has declined from last year -- a development which, among other things, reflects the recovery of Treasury revenues and an expenditure pattern still characterized by shortfalls. However, both the Administration's projection and the First Concurrent Resolution indicate that the deficit for fiscal year 1978 will substantially exceed that in the current year. If actually realized, this would be an unusual development. Normally, of course, Federal borrowing diminishes in the course of an economic expansion. In view of the probable need to finance an increasing volume of private capital formation, the prospect of greater demands for funds by the Federal Government in the next fiscal year has been a cause of some disquietude in financial circles.

The strong demands for money and credit that have accompanied our economic expansion have been reflected in a rise of short-term interest rates since the turn of the year. The Federal Reserve might have accommodated credit demands by providing bank reserves more liberally. However, such a course would only have postponed briefly the rise in interest rates because the resulting build-up of liquidity would have intensified inflationary expectations. By responding promptly to the enormous expansion of the monetary aggregates in April, the Federal Reserve gave clear notice that it was alert to the danger of a new wave of inflation. This reassurance to the business and financial community that the Federal Reserve would not permit the money supply to run riot was well received by credit markets. Long-term interest rates, of course, are of much larger significance to the economy than short-term rates; but the long-term rates are also especially sensitive to inflationary expectations. It is well, therefore, to take note of the fact that interest rates on corporate and municipal bonds, instead of following the recent rise in short-term rates, remained fairly stable and are actually a little lower now than they were in April.

These developments in credit markets are, I believe, attributable in significant part to public confidence in the Federal Reserve's monetary policy. It is noteworthy that, in general, interest rates still remain below levels prevailing at the beginning of the economic recovery.

During the past half year, the Federal Reserve has managed to keep the growth of the major monetary aggregates on a moderate path. M_1 -- which consists of currency and checking accounts at commercial banks -- increased at an annual rate of 6.4 per cent. This is a faster rate of growth than occurred last year, and it reflects the very intense demand for transactions balances in recent months. Growth of the broader aggregates, on the other hand, has been slower than last year -- a deceleration due partly to the low personal saving rate that has evolved and partly to some modest re-direction of savings flows away from deposit accounts to market securities as short-term interest rates have risen. Despite the moderate slowing of the broader monetary aggregates, financial institutions -- both commercial banks and the thrift institutions -- remain relatively liquid and in a good position to continue supporting economic expansion.

During the next few quarters, it is improbable that over-all economic growth will proceed as rapidly as it did during the past six months. Typically, bursts of consumer spending of the kind witnessed this year are followed by phases of moderation. Such moderation, indeed, seems to be signaled by recent data on retail sales. Nor, of course, is it to be expected that inventory investment will be adding as much to economic expansion as it did in preceding quarters. And in view of the high rate of single-family housing starts already attained, it is likely that housing will contribute less to growth.

These probable developments, however, do not portend an end to general economic expansion. We at the Board anticipate continuing growth -- albeit at less rapid rates -- in consumption, inventory investment, and homebuilding. We think, moreover, that investment activity by business firms will maintain a good growth pace and perhaps accelerate as businessmen are confronted, as they may well be, by reduced capacity margins next year. Meanwhile, as I noted earlier, there is reason to expect that the pace of State and local government spending will continue to quicken. What these various trends suggest is a change in the character of the expansion -- with the over-all growth rate slowing but still high enough to produce some further reductions in unemployment.

The fact that the Nation's unemployment rate remains high by historical standards is a source of continuing concern. If we as a people are to address this problem effectively, our first task is to understand the special factors that make it so difficult now to achieve rapid reductions in joblessness.

The stickiness of the unemployment rate, it needs to be appreciated, does not reflect unusual slowness in the opening up of new job opportunities during the current expansion. On the contrary, the growth of jobs since the recession trough in March 1975 -- some 6-1/2 million -- has been more rapid than during the comparable phase of any cyclical recovery since World War II. It happens, however, that the rate of increase in the labor force also has been unprecedentedly rapid in the course of this expansion -- amounting to more than 5-1/2 million persons. Consequently, despite the huge rise that has occurred in employment, the reduction in over-all unemployment has been modest.

The single most important reason for the fast pace of labor force growth has been a veritable rush of adult women into the job market. Indeed, of the increase of 5.6 million that has occurred in the labor force since the recession trough, 2.4 million -- or more than 40 per cent -- is accounted for by women of age 25 or over. Strikingly, if the percentage of this adult female population in the labor force had been the same in June 1977 as it was in March 1975, when economic recovery started, the adult female labor force would have been lower by 1-1/2 million this June. What we are witnessing, literally, is a revolution in the role of women in our society, and we need to focus on the economic implications of this phenomenon more carefully than we have.

Obviously, the fact that the labor market has had to absorb the "extra" influx of female job seekers is a major reason why the Nation's over-all unemployment rate has not moved downward more decisively. The rapid influx of women into the labor force takes on particular significance because it happens to reinforce another demographic factor that also is taxing the absorptive capabilities of the labor market. I refer to the continuing large additions of young people to the labor force -- a reflection of the high birth rates of the 1950's.

Both adult women and young people tend to experience unemployment rates above average. Many have never held a regular job before. Others left the work force years earlier on account of marriage or the arrival of children. Whatever the state of the labor market, a decision to enter or reenter the labor force often involves a fairly extended period of job hunting -- frequently prolonged by lack of knowledge about available job opportunities. For married women -- especially those with young children -- the desired job is often part-time and close to home, so that finding the right position may take quite a lot of time. For young people, early work experience frequently involves various job shifts -- and sometimes several periods of unemployment -- until a job considered appropriate is found.

Because of the decline in birth rates which started in the early 1960's, growth in the younger-age component of the labor force can be expected to taper off in the next few years. But no sign of tapering is as yet visible in the labor-force participation by adult women. A decided slowing of the inflation rate -- if that were to occur -- might check the rise in female labor-force participation, since some women clearly have taken jobs in order to offset the effects of inflation on household budgets. However, social trends seem to be of greater significance in conditioning the movement of women into the labor force. Attitudes toward child-bearing and child-rearing and toward educational and career aspirations of women have been undergoing dramatic changes in our society, and it cannot be foretold when this process will wane.

Thus rapid labor force growth may persist, thereby continuing to make it difficult to reduce the over-all unemployment rate to levels that were once considered reasonably consistent with the goal of full employment. Indeed, the changed age-sex composition of the labor force -- now weighted more than formerly toward groups that tend to have higher than average unemployment rates -- probably has imparted an upward tilt to over-all unemployment of about one percentage point compared with 20 years ago.

In time, of course, as women gain experience in the labor market and as businesses adapt their operations so as to employ women more effectively, the upward bias should lessen. One of our prime policy objectives certainly should be to facilitate the assimilation of adult women and young people into the active work force. That is not likely to be accomplished by actions that rely simply on boosting aggregate monetary demand. Such actions would tend to accentuate inflationary pressures in the economy without doing a great deal to facilitate the desired assimilation. In fact, the need to protect family incomes against the ravages of inflation may cause even more women and young people to enter the labor force. We therefore need to recognize very clearly that accommodation of significant changes in the labor market requires policies that are specifically tailored to the elimination of structural hindrances to full employment.

Even before the sharp acceleration of growth in the entry of women into the labor force, there was reason to be concerned that reasonably full use of our commercial and industrial capacity might be reached before we began approaching full employment of our labor force. That concern, arising from the laggard behavior of capital formation, is now greater because of the unexpected rapidity with which the labor force is expanding. The inference seems inescapable that we need governmental policies that offer decisive encouragement to capital formation. Unless recognition of that need conditions the evolution of policies in such major areas as energy, taxes, social security, welfare, and governmental regulation, there will be small hope of maximizing job opportunities in the next several years.

We need an environment that is decidedly more conducive to business risk-taking than that which has prevailed in recent years. In my judgment, we are very much in danger of forgetting that ours is basically an enterprise economy whose vitality depends on whether business firms are able to earn an adequate rate of return on invested capital. Despite the increasing role of government in economic activities, profits are still the essential driving force of our economic system. Economic discussions nowadays deal extensively with the effects of monetary and fiscal policies on economic activity; but they do not focus frequently enough on the even more important matter of whether private businesses -- which dominate job creation in our system -- have adequate incentive to expand their operations or to undertake new ventures. Our citizenry may pay dearly if this myopia persists.

It also is important to rethink some of our national policies with respect to the market for jobs. One of the most critical needs is to avoid governmental actions which compound the problems that newcomers to the job market already have. New entrants -- whether young people or adult women -- often cannot be highly productive in the initial phase of their employment. Minimum-wage legislation is blind to that fact, and thus limits employment opportunities for job seekers with little or no recent work experience. With young people and other newcomers to the labor force now accounting for a disproportionate share of the unemployed, this is hardly an opportune time for Congress to contemplate a boost in the minimum wage that goes well beyond the President's original recommendation.

Statutory changes in minimum wages affect not only the lower end of the wage spectrum. In practice, they tend to have a leveraging effect on the general wage structure as various tiers of workers seek to maintain the differential between their wage and that of lower paid workers. Such a development would reinforce the upward pressure on wages that already derives from the continuing advance of consumer prices, from tight labor markets here and there, and from large and well-publicized collective bargaining settlements in some industries.

Labor costs per unit of output in the private business sector rose by 5.4 per cent in the year ending in March. This increase reflects the difference between an average increase in labor compensation per hour of about 8 per cent and an average increase of 2-1/2 per cent in output per manhour. Since we are now in a phase of the business cycle when productivity gains are more likely to slow than to accelerate, the upward pressures on wages may lead to still stronger pressures on unit labor costs. Many businesses -- not always justifiably -- already feel a need to recoup labor-cost increases or to increase profit margins. To the extent that they succeed in raising their selling prices, the inflation rate will tend to worsen and so too will inflationary expectations. To the extent they fail, profits margins may narrow -- a development that would diminish the likelihood of sustained expansion of capital investment.

The need to concern ourselves with impending cost distortions and inflationary trends is evident from the price record of the first half of this year. That record, to be sure, was influenced by some transitory forces, and there has been some diminution in the rate of inflation lately. Even so, the rate of inflation this year is running higher than it did last year. This is a disturbing development for international as well as for domestic reasons.

In recent weeks, the dollar -- which had maintained remarkable stability against the average of foreign currencies since early last year -- has experienced limited but conspicuous depreciation. This is a matter that no one in our government can or does take lightly: first, because any material depreciation of the dollar against foreign currencies would have some adverse effect on our domestic price level; second, because the dollar is a store of value for much of the rest of the world. The fact that the dollar has weakened even in relation to the currencies of countries experiencing much greater inflation than the United States is a reminder that market psychology has a way of magnifying or distorting for a time underlying trends. A sound dollar is essential to our economic future and everyone with major financial responsibility in our government is keenly aware of that.

We at the Federal Reserve have persistently sought to protect the integrity of the dollar and at the same time foster further economic expansion. The members of the Federal Open Market Committee, when they met earlier this month to discuss the longer-run growth of the monetary aggregates, carefully considered international as well as domestic developments. The Committee decided to leave unchanged for the year ending in the second quarter of 1978 the previously projected growth ranges of the broader monetary aggregates. M_2 thus is projected to grow within a range from 7 to 9-1/2 per cent during the next year, and M_3 within a range from 8-1/2 to 11 per cent. An adjustment, however, was made in the growth range for M_1; the lower boundary of this range was dropped by one-half of a percentage point, so that this aggregate is projected to increase within a range from 4 to 6-1/2 per cent in the year ahead.

The adjustment in the projected growth range for M_1, while small, represents another step toward bringing the long-run growth of the monetary aggregates down to rates compatible with general price stability. Sustained progress in this direction is essential if the Administration's publicly announced goal of reducing the pace of inflation by about two percentage points by the end of 1979 is to be achieved.

The trend of growth in monetary aggregates, I regret to say, is still too rapid. Even though the Federal Reserve has steadily sought during the past two years to achieve lower ranges for monetary expansion, the evolution of its projections has been extremely gradual; indeed, at the pace we have been moving it would require perhaps a decade to reach rates of growth consistent with price stability. I must report, moreover, that despite the gradual reduction of projected growth ranges for the aggregates during the past two years, no meaningful reduction has as yet occurred in actual growth rates. That unintended consequence is partly the result of data deficiencies that complicate the already formidable task of adjusting or approximating monetary growth objectives. Some of the data deficiencies we have experienced are being overcome. Even so, monetary measurement will continue to lack the precision of a science. So too will the Federal Reserve's actions aiming to influence developments in financial markets.

Implicit in our projections for monetary growth is the expectation that the velocity -- or turnover -- of M_1 will increase at a faster rate than it has on average during comparable periods of previous business-cycle expansions. That does not seem an unreasonable expectation, inasmuch as the velocity of M_1 has in fact been increasing more rapidly during the current recovery than the historical record would have suggested -- a development that reflects the increasing importance of a wide range of substitutes for traditional checking deposits. The Federal Reserve Board's staff estimates that the growing use of such substitutes -- for example, NOW accounts, credit union share drafts, drafts on money-market mutual funds, passbook savings accounts for business firms and State and local governments, and telephonic transfers from savings to checking accounts -- depressed the rate of growth of M_1 by about 1-1/2 percentage points in 1976. This year the impact may be smaller but nonetheless will remain significant.

The relationship between monthly or even yearly rates of monetary expansion and the performance of the economy is subject to considerable uncertainty under the best of circumstances. In the current environment of rapid change in methods of carrying on financial transactions that uncertainty is heightened. Consequently, the Federal Reserve will continue to maintain a posture of vigilance and flexibility in the period ahead. Current monetary policy represents our best judgment as to what is appropriate in the light of evolving economic and financial developments. We will not be slow in modifying that policy if actual conditions deviate materially from our expectations.

In concluding this report, I think it appropriate to emphasize the great complexity of the economic problems currently confronting our Nation. There are no instant, easy solutions that will deliver us from our difficulties. For our part, we at the Federal Reserve know that inflation ultimately cannot proceed without monetary nourishment. But we also live with a realization of our limited capacity to move dramatically or quickly in making means of financing less readily available.

The shock of abrupt adjustment after so many years of drug-like abuse of our economic system would be excessively risky. To the maximum extent feasible, however, we are determined to move toward reestablishing conditions of financial order in our society. That is not because financial order is itself an end with which we are preoccupied, but because our Nation cannot realize its potential for sustained prosperity and well-being until existing apprehensions about inflation are subdued.

We at the Board have no illusions about what the Federal Reserve alone can accomplish. Sound monetary policy is a pre-requisite to the achievement of the employment and price goals set forth by the Administration. But other elements are no less critical. The President's timetable for eliminating the deficit in the Federal budget deserves the earnest support of the Congress. Structural rigidities that are weakening our economy also require serious attention. It is fortunate that members of the Congress increasingly perceive that persistent budget deficits and ever faster increases of the money supply, whatever their usefulness in the past, are no longer capable of solving our economic problems.

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