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Statement by

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before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

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I am pleased to appear today, for the first time, to present the Federal Reserve's report on the conduct of monetary policy. This will also be our first report since passage of the Federal Reserve Reform Act of 1977, which originated in this Committee and which wrote into law the monetary oversight hearings that had been held quarterly in recent years. These hearings have provided a useful forum for discussion of economic and financial conditions and monetary policy. I have no doubt that they will continue to do so, and look forward to participation in them.

During the past year, the Federal Reserve continued to pursue the objective of fostering financial conditions consistent with expansion of economic activity and moderation of inflationary pressures. Gross national product--the broadest measure of economic activity--rose 5¾ per cent in real terms during 1977, about the same rapid pace as we experienced on average in the earlier stages of the current recovery. However, the rate of inflation remained disturbingly high.

Very recently, sales and production have weakened, but this seems to reflect mainly--if not entirely--the temporary effects of the unusually severe winter weather and the coal strike. While prolongation of the strike could lead to more extensive economic disruption, basically our economy is strong, and the year 1978 should see continued expansion in economic activity at a moderate pace and a further reduction in the unemployment rate. At the same time, recent trends provide little basis for optimism with regard to an abatement of inflationary pressures.

The brisk increase in production last year made it possible to reduce unemployment significantly despite further large growth in the size of the nation's labor force. In the past twelve months, the jobless rate has fallen more than a percentage point. Total employment has risen by more than 4 million, and the proportion of our population that is employed stands at the highest level in the postwar period.

The advance of production and employment during the past year was broadly based, with most of the major sectors of aggregate demand registering good gains. Consumer spending followed an uneven course during 1977, but for the year as a whole growth was substantial by historical standards. Residential construction continued to provide considerable impetus to expansion, with single-family housing starts reaching an exceptionally high level and multi-family building also posting appreciable gains from earlier depressed levels. Business fixed investment expanded somewhat more rapidly in 1977 than in earlier years of the recovery, although such investment continued to lag well behind its performance in previous cyclical upswings. The pace of governmental spending--at both the Federal and the State and local levels--also picked up last year.

As domestic activity expanded rapidly, our imports of goods from abroad continued their steep climb, boosted by our increasing appetite for imported oil. Meanwhile, the sluggish performance of economic activity in other major industrial countries limited the demand for our exports. As a result, our trade deficit deepened from about $10 billion in 1976 to more than $30 billion in 1977.

The widening of the trade deficit contributed importantly to the downward pressure on the exchange value of the dollar over the past several months. The Federal Reserve, in cooperation with the Treasury, has taken steps to counter disorder in foreign exchange markets and to emphasize U.S. concern about the integrity of the dollar. But the key to a sound dollar and a stable world financial system lies ultimately in the resolution of some of our fundamental, longer-range economic problems. In particular, we must establish an energy policy that promises to reduce our reliance on foreign sources of petroleum; we must create a better climate for business investment, so as to enhance labor productivity and to increase our international competitiveness; and most importantly, we must make progress toward the restoration of domestic price stability.

One of the great disappointments of the past year has been the lack of progress in reducing the pace of inflation. Wage increases have continued to outstrip gains in output per hour worked; unit labor costs in private industry have again risen substantially;

and prices have been trending upward at about a 6 per cent annual rate.

Prudent monetary management is, of course, an essential ingredient in the control of inflation over the longer run. Too much money growth would add to inflationary pressures and would tend to encourage still larger increases in wages, costs, and prices.

Confronted with very strong demands for money and credit this past year, the Federal Reserve took actions to moderate monetary growth and to help ensure that inflationary forces would not get out of hand. Although interest rates have risen, domestic financial markets have remained supportive of economic growth. Supplies of credit have been ample, with the total volume of funds raised in the nation's money and capital markets approaching $400 billion in 1977--a record both in dollar terms and as a percentage of GNP.

In the household sector, mortgage loans accounted for the bulk of an unprecedented increase in indebtedness. Families sought mortgage credit not only to finance the purchase of homes, but also to fund other expenditures and to add to their holdings of financial assets. Meanwhile, consumer instalment credit grew very rapidly, especially during the first half of the year when sales of new cars were strongest.

Borrowing by nonfinancial business firms also rose sharply in 1977. The volume of new publicly offered bond issues fell off somewhat from the preceding year, as many of the larger, higher-rated companies had completed the restructuring of their debt in 1975 and 1976. But lower-rated firms continued to place large quantities of bonds privately with life insurance companies and other lenders. And companies of all types tapped financial institutions for increased amounts of mortgage and term loans, as well as for short-term credit.

Governmental demands for credit in 1977 remained exceptionally large by historical standards. Borrowing by State and local units surpassed previous levels by a wide margin. A substantial portion of the increase in tax-exempt bond issuance was for the advance refunding of debt obligations incurred in prior years when interest rates were higher, but States and municipalities also borrowed large amounts for current and future capital outlays. At the Federal level, the outstanding volume of Treasury debt rose by the third largest amount in history, as a consequence of the U.S. Government's large budget deficit. Financing of the continued Federal deficit contributed to upward pressures on interest rates last year--a year in which private credit demands were especially strong.

In an environment of briskly expanding economic activity and credit demands, the monetary aggregates also tended to grow more rapidly last year. The public's demand for M-1--currency and checking account balances--strengthened considerably, and growth in this measure of money accelerated. Over the year as a whole, M-1 grew about 7½ per cent, well in excess of the range established by the Federal Reserve. The broader monetary aggregates--M-2 and M-3--grew at rates near the upper end of the ranges that had been adopted by the Federal Reserve in early 1977.

Knowing that a sustained, rapid monetary expansion would threaten a build-up over time of inflationary pressures, the Federal Reserve began in early spring to be less accommodative in its provision of reserves to the banking system. The adjustment of policy was a cautious one, in view of the possibility that the burst of monetary expansion that had developed might reflect simply a transitory swing in the public's demand for cash balances. But as relatively rapid monetary expansion continued, the Federal Reserve gradually exerted increasing restraint in the provision of bank reserves relative to the strong demands for them.

As a result, the Federal funds rate--the rate banks pay to borrow reserves from one another on an overnight basis--rose about 1¾ percentage points from April to October, reaching a level of about 6½ per cent. And the discount rate at Federal Reserve Banks was raised in two steps to 6 per cent by late October. Subsequently, in early January, the discount rate was increased to 6½ per cent and the Fed funds rate was moved slightly higher to help stabilize conditions in the market for dollars on international exchanges.

Over-all, since last April short-term market rates of interest have risen about 2 percentage points. Intermediate- and long-term yields have also risen, with increases largest in the market for Treasury securities, where rates have adjusted upwards by ¾ to

$1\frac{1}{2}$ percentage points over the past 10 months. These increases in interest rates on longer-term securities may well have reflected some increase in the inflation premium, as investors reacted to the lack of progress in reducing inflation. Nevertheless, despite the increases of the past year, most short-term rates are still less than 1 percentage point above their levels at the beginning of the present economic expansion in early 1975, and corporate and municipal bond yields are significantly below their levels then.

Growth rates for all the monetary aggregates have slackened appreciably, on average, in the last few months. Growth in M-2 and M-3 has slowed in part because the rise in interest rates on market instruments has made them more attractive to some savers than interest-bearing deposits at banks and thrift institutions. At the same time, however, demands for loans at depository institutions have remained strong. Under the circumstances, these institutions have had to supplement their deposit flows by borrowing and by reducing their holdings of liquid assets.

Although these pressures may be causing depository institutions to become a bit more cautious in their lending policies, credit supplies still appear to be ample. Moreover, the financial condition of the key nonfinancial sectors remains generally strong. It is true that household debt burdens, as measured, for example, by the ratio of consumer and mortgage loan repayments to disposable income, are historically high, and they deserve careful monitoring. But to date, there has been no rise in delinquency rates, so that families appear thus far to be handling their increased indebtedness well. Businesses added further to their liquid assets last year, and corporate balance sheets on the whole appear to be strong, although there is considerable variation from firm to firm. And State and local governments, with record operating surpluses in 1977, appear in the aggregate to enjoy a healthy financial position.

Thus, financial conditions remain supportive of expansion in economic activity. As 1977 drew to a close, aggregate demands for goods and services were strong. As I noted earlier, severe winter weather and the coal strike have caused some steep declines in economic indicators recently. However--assuming a reasonably prompt resumption of activity in the coal industry--we can expect favorable underlying trends soon to reassert themselves. Growth of employment and income has been substantial over recent quarters, and consumer confidence has remained high. Consumer spending, therefore, should grow at a reasonably good pace, and would be bolstered later this year by the proposed tax cuts. In the business sector, new orders for nondefense capital goods have continued the uptrend that began about three years ago, and presage further expansion in business fixed investment. In addition, the rate of inventory accumulation is likely to accelerate in coming months; inventory investment had slowed in the fourth quarter, and stocks are lean in many product lines. Moreover, with prospects for our exports improved by the likelihood of stronger economic growth abroad this year, it appears that our foreign trade deficit will not deteriorate further.

Over-all, it is the Federal Reserve's judgment that trends in the national economy favor continued expansion at a moderate rate in economic activity and a further reduction in the rate of unemployment over the course of 1978. There is, however, less reason to be sanguine about progress in curbing the rate of inflation. Food and material prices have risen substantially in recent months. And labor costs continue to rise at a relatively rapid rate. The decline in the value of the dollar on international exchanges is another cause for concern. It not only contributes to upward pressures on domestic prices but also threatens to erode business confidence here and abroad.

The monetary growth ranges that were adopted by the Federal Open Market Committee at its February meeting are expected to prove consistent with continued expansion in economic activity, as well as with a gradual winding down of inflation over the longer run. For the year ending with the fourth quarter of 1978, the M-1 growth range was set at 4 to 6½ per cent. A range of 6½ to 9 per cent was established for M-2, which includes, in addition to M-1, time and savings deposits other than large CD's at commercial banks. And a growth range of 7½ to 10 per cent was adopted for M-3--which includes, besides M-2, deposits at nonbank thrift institutions.

The ranges for M-1 and M-2 are identical to those that the Committee previously had adopted for the year ending in the third quarter of 1978. The range for M-3, however, has been adjusted downward by ½ percentage point in light of the higher level of market interest rates now prevailing and the apparent effect of these rates in retarding growth in time and savings deposits at thrift institutions. All of the ranges adopted by the FOMC anticipate a deceleration of monetary expansion from the growth rates actually recorded in 1977. Progress over time in this direction is necessary to ensure the ultimate achievement of reasonable price stability.

Specification of growth rates for the aggregates is, of course, subject to considerable uncertainty. The rate of growth in money needed to support economic expansion depends in part on changes in the velocity of money--that is, on the rate at which the public uses the existing stock of money to finance transactions. In recent years, regulatory changes and financial innovations have encouraged increases in the velocity of M-1 by enabling the public to economize on demand deposits. However, the retarding effect of such changes and innovations on the demand for M-1 apparently diminished in 1977, when M-1 growth accelerated. Thus far in 1978, growth in M-1 has been quite moderate, but it is far too early to say whether this marks a slower trend in growth or is simply a transitory development in a highly volatile series.

The behavior of the broader aggregates--M-2 and M-3--will be affected in the year ahead by the constraint placed on the ability of depository institutions to attract funds under existing regulatory ceilings on deposit rates. Banks have adjusted to the recent marked slowing of inflows of deposits subject to rate ceilings in part by offering increased amounts of large-denomination time deposits, which are not subject to ceilings. Some of these deposits, mainly large-denomination deposits issued in non-negotiable form, are included in M-2 and M-3; they have tended to sustain growth in these aggregates, especially M-2, in recent months.

There are other factors that may work to sustain growth in the broader aggregates in the year ahead. To some extent, the recent slowdown in inflows of savings and also small-denomination time deposits may represent a one-time shift of highly interest-sensitive funds; if so, once the shift has been completed, deposit growth should strengthen somewhat. Moreover, the fact that longer-term time certificates, which are subject to heavy penalties for early withdrawal, account today for a larger share of interest-bearing deposits--especially at thrift institutions--suggests that overall deposit growth should be less volatile than in the past.

Nonetheless, if heavy demands for money and credit should place further upward pressure on market interest rates, deposits subject to regulatory rate ceilings will be placed at a substantial competitive disadvantage. In such a circumstance, growth in M-2 and M-3 could fall short of the ranges. Upward adjustments in the ceiling rates on some or all categories of time deposits may be required to avoid a potential distortion in the flow of credit through our financial system, to promote equity for small savers, and to ensure the availability of loans to home buyers and others who rely on institutional sources of credit.

We recognize, however, the considerable uncertainties surrounding the shorter-run relationship between growth rates of the monetary aggregates, on the one hand, and the behavior of output and prices on the other. The Federal Reserve will continue, therefore, to maintain a vigilant and flexible approach, putting the long run performance of the economy above the pursuit of any fixed monetary growth rates.

Economic and financial developments in the current year, it should be noted, will depend to an appreciable extent on governmental policies beyond the province of the Federal Reserve. The outcome of legislative action on energy policy and on taxation will have a considerable influence on the strength of business investment and on international confidence in the dollar. So, too, will this nation's ability to find a way to reduce the upward wage-price pressures that continue to plague our economy.

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