For Release on Delivery

Statement by

G. William Miller

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

June 29, 1978

Mr. Chairman, I appreciate this opportunity to participate on behalf of the Federal Reserve Board in the Joint Economic Committee's mid-year review of the economy. These sessions provide an excellent opportunity to assess economic conditions and policies.

. ECONOMIC ACTIVITY EXHIBITS HEALTHY GROWTH

The economy has continued to expand at a satisfactory though uneven rate over the first half of this year. Industrial production, construction, and retail sales were temporarily depressed early in the year by unusually severe weather and the long coal strike, as shown in Chart 1. But these were transitory effects--and business activity recovered vigorously in the spring. For the first six months of the year, real annual growth in the gross national product appears likely to average around 4 per cent--close to the pace during the latter half of 1977. Thus, despite the considerable volatility in key areas of the economy, the underlying momentum of the expansion appears to have been well maintained.

The strength of aggregate demand has stimulated a substantial further improvement in the job market. As is indicated in the bottom panels of the Chart, employment gains have been exceptionally strong. More than 2 million nonfarm jobs were created over the last six months, which lowered the unemployment rate by more than one-half of a percentage point to just over 6 per cent of the labor force. The jobless rate for heads of households fell one-half percentage point to 3.7 per cent. The proportion of the working-age population with jobs has moved up to 58.6 per cent, a new record high. The sustained strength of demand for workers suggests that businessmen remain optimistic, and are prepared to increase production and other activities further.

. AND GROWTH PROSPECTS REMAIN FAVORABLE

Growth of economic activity recently has slowed, as was expected, from the unusually rapid pace of the spring. A moderate rate of economic growth appears to be a reasonable prospect for the balance of the year. Both consumer outlays and business spending should provide support for further expansion of activity. Consumers' demand for new cars has been particularly strong, and the current rate of sales is the highest in this expansion. The advanced sales pace may, in part, represent purchasing in anticipation of further price rises. But surveys indicate that consumer confidence remains generally high, although there has been some recent moderation, and if growth of income is sustained, the prospects for further gains in consumer spending appear good.

Business outlays for both inventories and fixed capital goods have contributed significantly to the recent pace of activity. A larger rate of inventory accumulation was to be expected, in light of the burst of final sales late last year, and the damping effect of adverse weather on production during the winter. Inventories in most sectors appear quite low relative to sales, and continued growth of inventory investment--albeit at a more moderate rate--should be evident over the next few quarters. Business investment in plant and equipment, after lagging early in the economic upswing, has increased at a reasonably good pace over the past two years. While recent surveys have shown little propensity for business to scale up capital spending plans, these and other indicators of prospective capital outlays suggest further moderate growth in the year ahead.

Our foreign trade position should also lend moderate support to the economic expansion. Some pick-up in growth abroad and our improved competitive position should help to boost exports. However, U.S. demand for imports--both oil and other products--is likely to remain quite high.

Among other sectors of demand, State and local governments have maintained conservative spending policies for some time, and it is likely that the reverberations of the passage of Proposition 13 in California may be evident in an even more cautious pattern of outlays in the period ahead.

Residential construction activity is expected to begin to taper off later this year in response to tighter mortgage market conditions. However, housing starts were still above a 2 million annual rate in May, virtually assuring brisk construction activity over the next few months.

. BUT THE PRICE SITUATION HAS WORSENED

Thus in most respects the immediate outlook appears generally favorable. But in one critical regard the economic situation has deteriorated. The recent intensification of inflation, illustrated in Chart 2, raises profound questions in regard to the longer run. As can be seen in the Chart, the rate of price increase has accelerated sharply both at the consumer and producer level. A major factor was the effect on food prices of a decline in meat production. But other prices rose at an accelerated rate as well. Excluding food and energy, retail prices have risen at an annual rate of over 8 per cent so far this year, up from a 6-1/2 per cent rate of increase in 1977. Actions of the Government have also played a significant role in the recent worsening of inflation. Service prices have risen strongly, influenced importantly by the rise in the minimum wage on January 1. Moreover, increases in social security and unemployment insurance taxes have added to labor costs on a broad scale, while costly regulatory actions continue to put upward pressures on costs.

There is some hope that the exceptional rate of increase in food prices will moderate as the year progresses, but there is much less likelihood of any easing of underlying inflationary forces. The recent acceleration in consumer prices will add to the pressure for substantial wage boosts, and resulting higher labor costs will largely be transmitted through to prices.

. MONETARY POLICY HAS RESPONDED TO EMERGING DEVELOPMENTS

The faster pace of price increases in recent months along with the sizable expansion of economic activity has been reflected clearly in financial market developments. Demands for both money and credit have exhibited appreciable strength. The Federal Reserve, for its part, has moved carefully in the direction of greater restraint in order to ensure that excessive money and credit supplies do not add to powerful inflationary forces evident in our economy.

The firming of monetary policy was undertaken also in response to the clear tendency for monetary expansion to exceed the growth ranges that had been established. Transaction demands for cash balances have been especially sizable and the narrow money stock (M-1) has grown at an annual rate of nearly 8 per cent thus far this year, somewhat faster than the upper end of the long-run range the Federal Reserve has set.

In the presence of strong credit demands, the worsening of inflation, and the Federal Reserve's efforts to contain excessive monetary expansion, market interest rates have risen significantly further. Most short-term rates have risen by three-quarters to one percentage point since the beginning of the year and long-term bond yields have followed much the same pattern, as illustrated in Chart 3. The rise of market interest rates has been accompanied by slower growth of savings and small-denomination time accounts at banks and thrift institutions. As a result, growth rates of broader monetary aggregates--M-2 and M-3--have remained within the Federal Reserve's long-run ranges.

A good deal of the rise in interest rates this year can be attributed to the acceleration of inflation. For lenders, rising prices of goods and services result in an erosion in the purchasing power of loan principal. Consequently, when greater inflation is expected, a rise in nominal interest rates is necessary to offset such losses and maintain the incentive to extend credit. For borrowers, higher interest rates are less of an obstacle to incurring debt under conditions of accelerating inflation. Greater cost savings can be enjoyed by buying now rather than later, while tangible assets purchased appreciate more rapidly in value. Borrowers, moreover, can expect to support greater debt service burdens via faster nominal earnings growth due to accelerated rises in prices, wages and salaries.

The importance of such an anticipatory process is being demonstrated very clearly right now in the mortgage market. Evidently mortgage borrowers, while expecting their nominal incomes to continue to rise significantly, believe prices of homes also will escalate rapidly. Despite stiffer lending terms and higher interest rates on mortgages, home sales have continued high, and the demand for mortgage credit has remained very strong. Faced with reduced deposit inflows, thrift institutions have drawn down their liquidity and sharply increased their borrowing in order to accommodate these credit demands.

The Federal regulatory agencies have taken action recently to improve the competitiveness of deposits subject to regulatory ceilings by authorizing two new savings instruments--variable-ceiling, six-month certificates with interest rates tied to the discount yield on newly issued Treasury bills, and eight-year certificates carrying ceiling rates of 7-3/4 and 8 per cent for banks and thrifts, respectively. It is still too early to quantify the contribution of the new accounts, but early reports indicate considerable promotional activity on the part of depositary institutions and interest on the part of savers.

. CONSUMER AND BUSINESS CREDIT DEMANDS STRONG

Consumer borrowing through mortgage credit has been a principal influence in the sustained high level of total credit demands. Consumers have also taken on record amounts of new instalment debt to finance purchases of durable goods, especially cars (Chart 4). The rapid rise of household borrowing is a matter of concern. High debt is apt to constrain spending later on, and always carries the risk of financial difficulties for those who have borrowed heavily. Thus far, however, households generally appear to be handling their increased indebtedness well. While the ratio of consumer and mortgage loan repayments to disposable income is very high by historical standards delinquency rates have only recently edged upward and they remain well below recession peaks.

Business demands for credit have expanded sharply of late, owing partly to the growth of capital spending and the pronounced upturn in inventories (Chart 5). In addition, internal cash flows slowed early in the year as bad weather cut into sales and costs were pushed up by hikes in Government payroll taxes and in the minimum wage. Bank business loans rose at about a 20 per cent annual rate over the first five months, with the largest rises in March, April and May. With credit demands strong banks have borrowed heavily in money markets, through the issuance of large certificates of deposit and nondeposit liabilities.

. TOTAL GOVERNMENT BORROWING LARGE AS WELL

Government credit demands also have been large, as State and local units recently issued a particularly heavy volume of advance refunding obligations to take advantage of invested sinking fund provisions prior to a mid-May IRS ruling restricting securities with such provisions. Furthermore, Federal agencies have borrowed more to finance support activities in mortgage markets. Treasury borrowing--following heavy demands early this year--has moderated in recent months with the seasonal inflow of tax receipts.

INFLATION POSES THREAT TO THE ECONOMY

The recent acceleration of inflation has serious implications for continued economic growth. Unless inflation is brought under control, business and consumer confidence will be undermined, distortions and imbalances in the economy will develop, and ultimately recession will be the result. In this regard, the Administration's decision to request a delay in--and reduction of the size of--the proposed tax cut, as well as to hold down Federal spending, and to try to develop voluntary price and wage restraint are encouraging.

These recent steps do not constitute, by themselves, an adequate long-term attack on the inflationary practices and policies which have given the economy its inflationary bias. Inflation is now the Nation's most serious economic problem. Because high rates of inflation erode economic values and raise uncertainties about the future, they continuously undermine the incentives for saving and investment. Without adequate investment in new, more efficient technology, growth of productivity tends to slow--lending further momentum to cost-based inflationary pressures. It is for this reason--because deep-seated inflation retards long-run growth and is a clear threat to sustained high employment--that inflation must be characterized as our highest priority economic problem.

. NEED TO FOCUS ON MANAGEMENT OF SUPPLY

As this Committee has heard in recent weeks in its first series of hearings on economic change, a major impetus to inflation lies in problems on the supply side of the Nation's economy. Among these problems are:

- Inadequate growth of the capital stock;
- Inadequate training, experience, and mobility among many of the unemployed;
- Inadequate price competition in some product and labor markets; and
- Counter-productive, and frequently inefficient, Government regulation of private enterprise.

Individually these supply-side issues have been obvious for many years, but during the past three or four years there has begun to be a general recognition that they must be addressed collectively and aggressively if we hope to achieve our national economic objectives. Reorientation of the Nation's economic policy to emphasize supply management will take time and careful consideration of many alternatives. However, some aspects of the necessary reorientation already command general agreement. Perhaps the key element is to give renewed primacy to technological advance and productivity growth. Surely, the sorry productivity performance over the last decade has been a significant factor in the sustained inflation of the 1970's, and it clearly has played a role in weakening our international competitiveness.

. LARGER GAINS IN PRODUCTIVITY NEEDED

Improving productivity growth involves working on three key elements: labor, energy, and capital. Potential labor contributions to the restoration of faster productivity growth are many and varied. The Government has a role to play in enhancing labor productivity: it should focus its various labor market and welfare programs on skill training to the maximum practicable extent, and should carefully reexamine the cost and price implications of various labor market regulatory programs, and minimum wage policies.

The energy problem has two main elements: a need for research to find new sources of energy, and a need for appropriate incentives to encourage use of existing energy-efficient technologies. In this area, agreement on a national energy policy is long overdue, and the Conference Committee should intensify its efforts to reach a compromise on the Administration's proposals.

The capital problem is even more complex. In recent years, the stock of capital actually has declined relative to the labor force, (depicted in Chart 6), and this is undoubtedly one important factor in the slower growth of productivity.

. CAPITAL STOCK NOW INADEQUATE

Capital accumulation is the chief engine of long-range growth of labor productivity and rising living standards. Yet, for an extended period, the Nation's tax policies have not provided adequate incentives to invest in new capital. In particular, depreciation guidelines do not approach actual replacement costs in periods of rapid inflation.

I believe a near-term, partial answer is to introduce a more liberal variant of accelerated depreciation. Over time, careful reconsideration of all taxes on business is essential.

Because we have been neglecting capital accumulation and because the existing capital stock must also be adjusted to accommodate the reality of more expensive energy, a larger share of GNP must be devoted to capital investment. It will not be enough simply to reach the 10-1/2 to 11 per cent range that has been characteristic of past periods of prosperity and low unemployment. The Nation should set an ambitious objective for capital investment of, say, 12 per cent of GNP for an extended period to enable us to make up for past deficiencies and to narrow the gap between our performance and that of other strong industrialized countries.

. . RESOURCES MUST BE FREED FOR PRIVATE SECTOR USE

Fundamental to achieving this aim is an expansion in the savings available for investment from outside the business sector. To this end, Government must have a smaller role in the economy and budget deficits need to be eliminated over time, taking into account the ups and downs in the economy. The private sector can take up the slack if, over five or seven years, the Federal Government curtails the growth of its expenditures until their ratio to GNP, which is now above 22 per cent, is reduced to the 20 per cent range. This interim goal for Federal expenditures clearly is attainable with a good measure of fiscal discipline coupled with reduced public demands for government services.

As spending is brought under control, government will move from its position as a substantial net borrower of funds in credit markets. Such a change would moderate demand pressures on credit markets as well as relieve some of the pressures on prices that arise from passing on high and rising taxes. Resources will be more readily available to meet needs in the private sector. Easier credit market conditions, less inflation, and greater availability of resources should help ensure adequate residential construction activity to meet the Nation's housing needs--needs that are now prey to a boom and bust syndrome that profits no one.

. STRUCTURAL REFORMS REQUIRED AS WELL

Another essential element of a long-term strategy aimed at a high-growth, low-inflation economy is extensive reform of Federal regulatory activities. A critical look at price-regulating Government programs should be undertaken; a painstaking examination of all existing and proposed regulatory activities in the environmental and health and safety areas is also necessary. In this connection, the President's recent executive order to improve the regulatory process is encouraging. The Federal Reserve is a participant in this process and has initiated an over-all review of its own regulations.

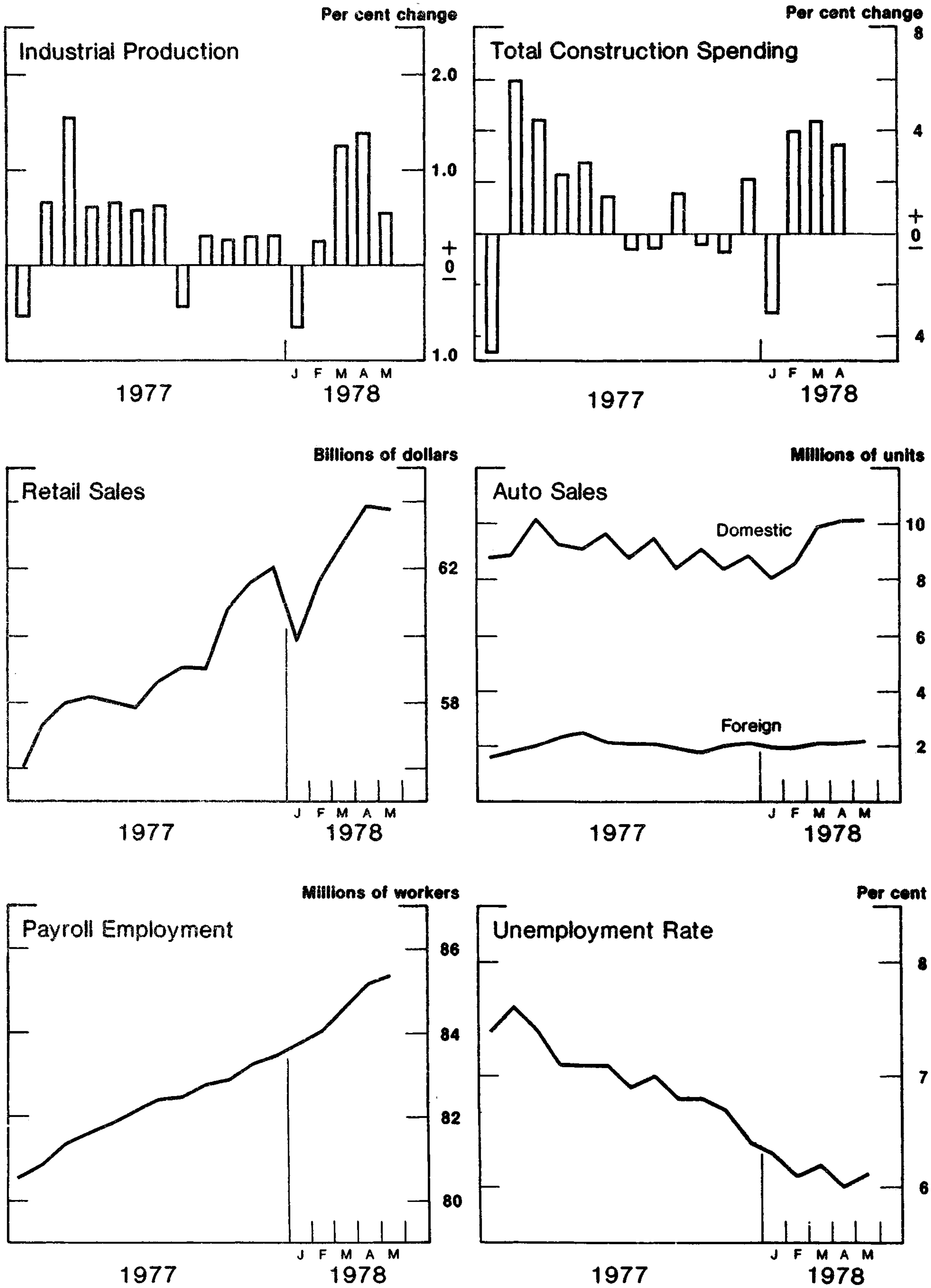
Another important element that requires immediate attention, and which should be an important part of a long-term strategy for the U.S. economy, is a reduction of our foreign trade deficit. A sound national energy policy that reduces our dependence on oil imports is certainly one ingredient. In addition, we must raise the consciousness of businessmen to the sales potential and profits that export markets can provide. The Government can help by continuing with other governments to resist protectionist pressures, and by simplifying, and where possible eliminating, those regulations that hinder our export trade. In my view, our ultimate objective should be to expand the share of exports in our national product to 10 per cent or so, in line with the secular rise in the share of imports.

I am convinced that the policy reorientation outlined above, by directly attacking inflation-causing conditions at their root, should lessen the burden on monetary policy and result in a better balance between fiscal and monetary policy, and thereby improve the prospects for lower interest rates. An economic program of this type would start the Nation on the road to becoming a model economy--an economy with a sound dollar, price stability, and sustained full employment. Our Nation has met bigger challenges, and, with a sense of commitment on the part of policy-makers and citizens, I am confident that we will meet this challenge as well.

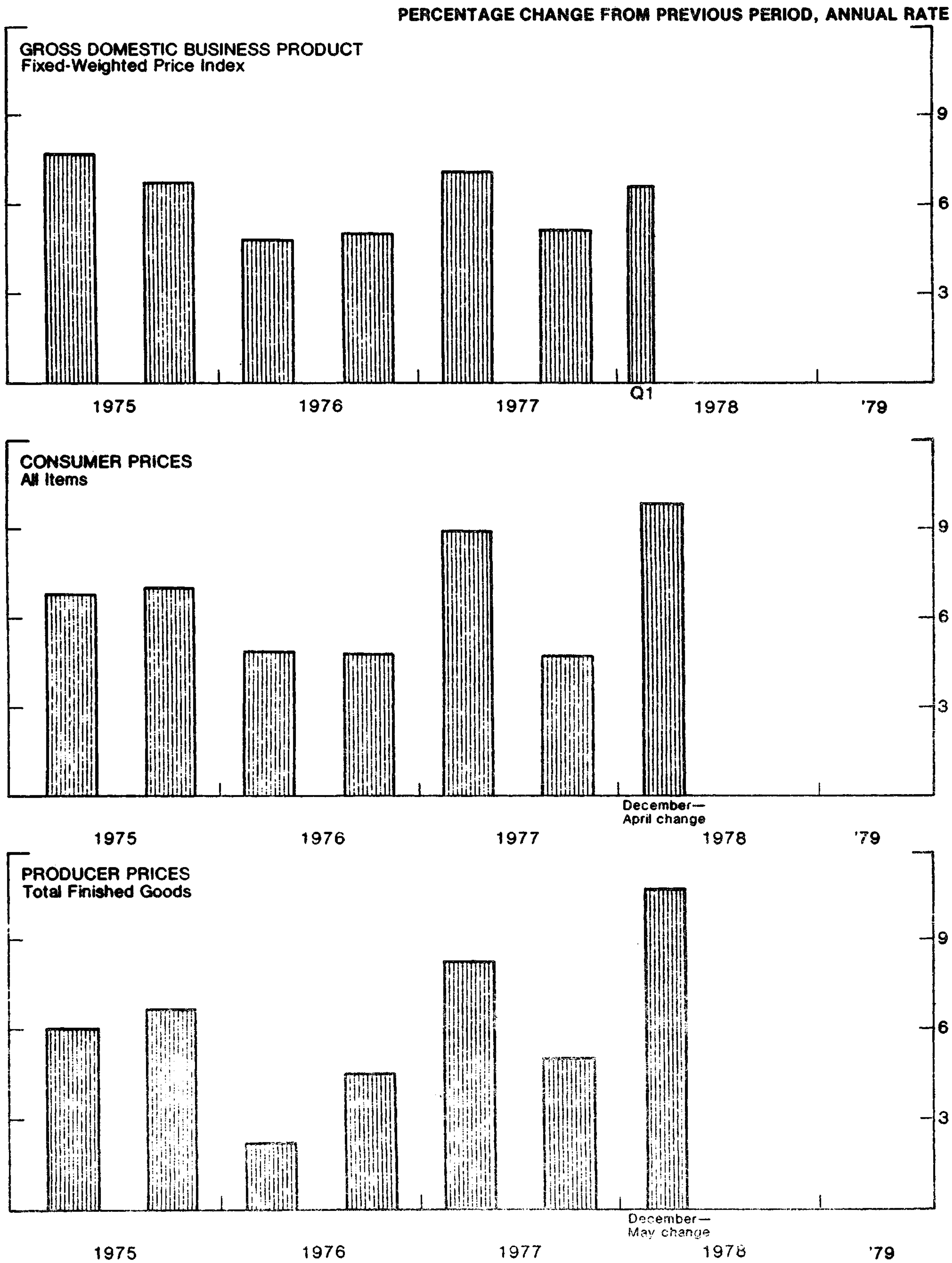
-0-

Chart 1

## CURRENT ECONOMIC INDICATORS



# MEASURES OF AGGREGATE INFLATION



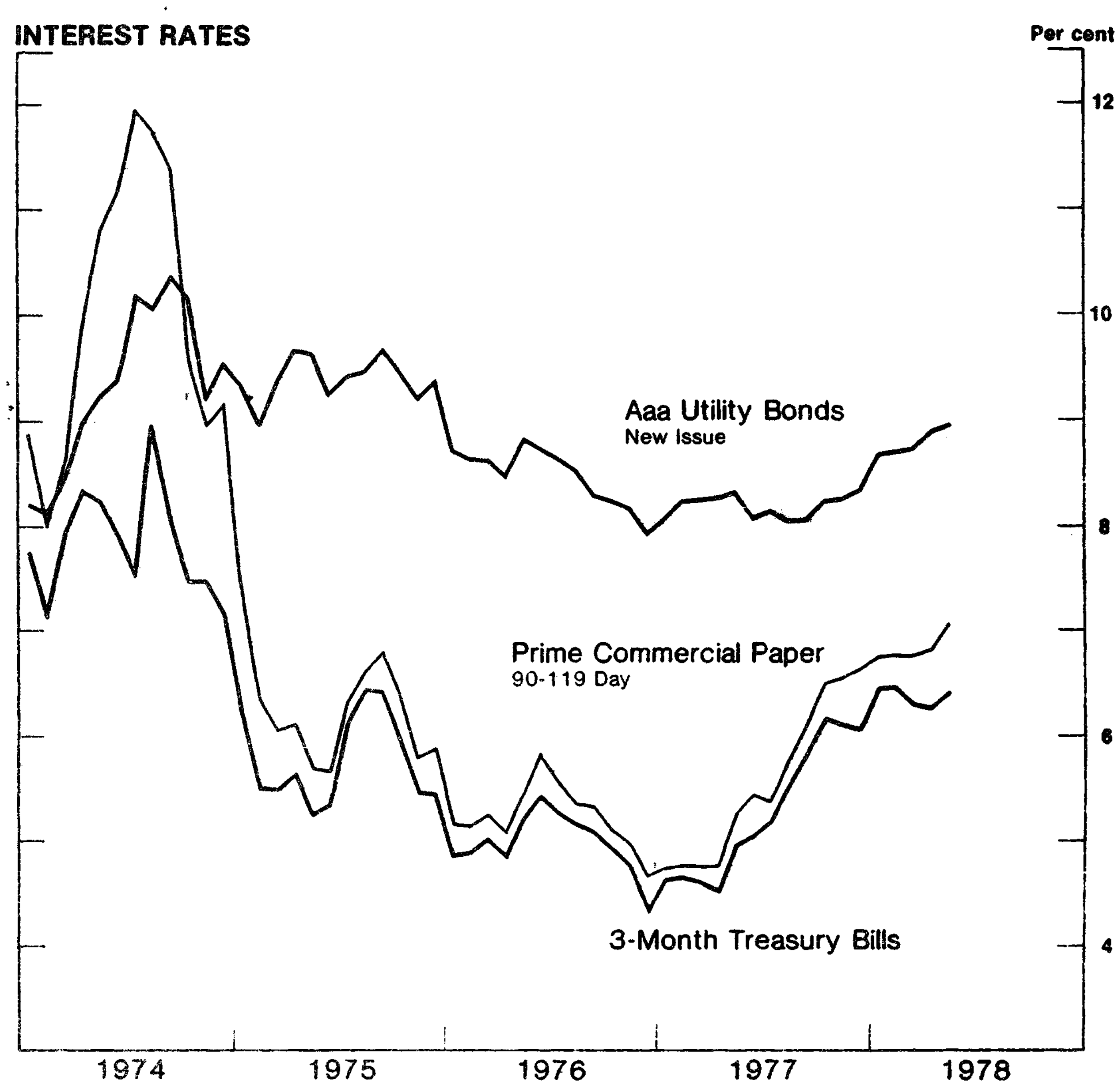
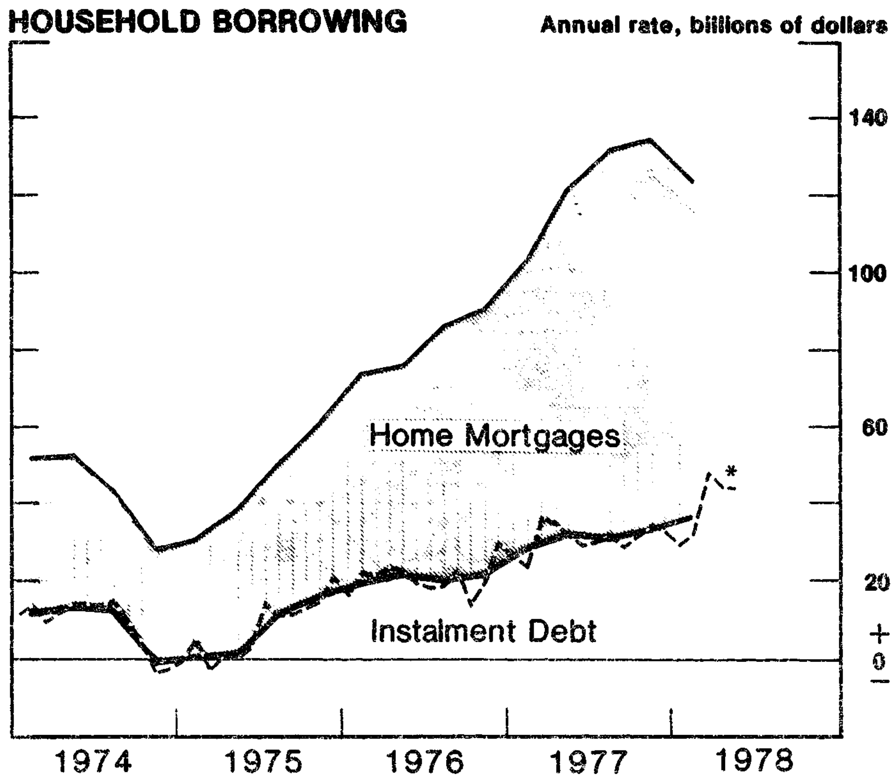
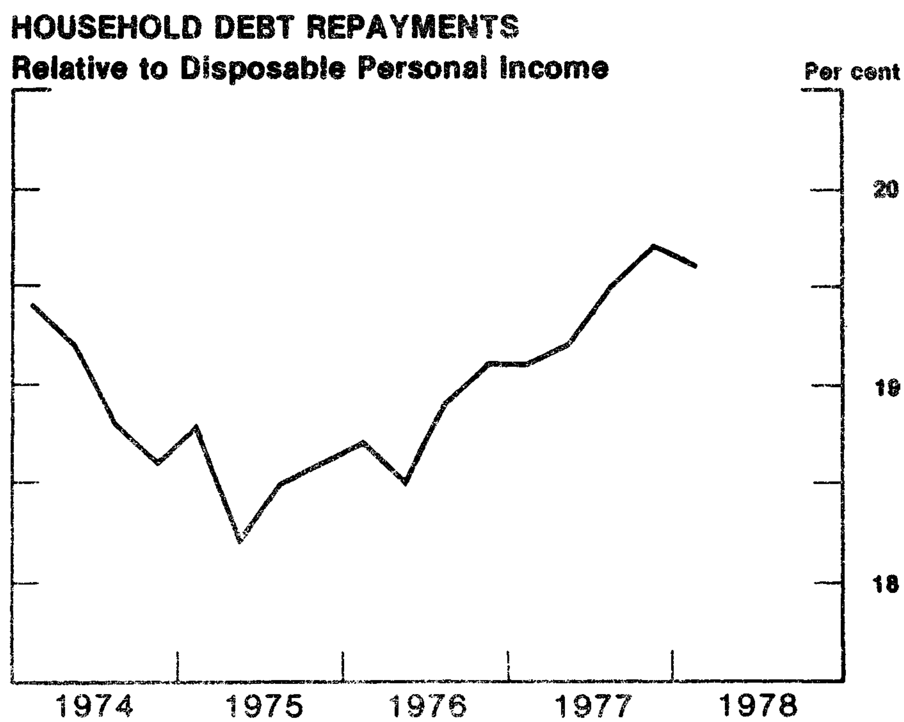

INTEREST RATES
Per cent
12
10
8
6
4
Aaa Utility Bonds
New Issue
Prime Commercial Paper
90-119 Day
3-Month Treasury Bills
1974
1975
1976
1977
1978

Chart 4




* Monthly net change in amount outstanding of Total Consumer Instalment Credit.

Chart 5

## SELECTED BORROWING BY NONFINANCIAL BUSINESS

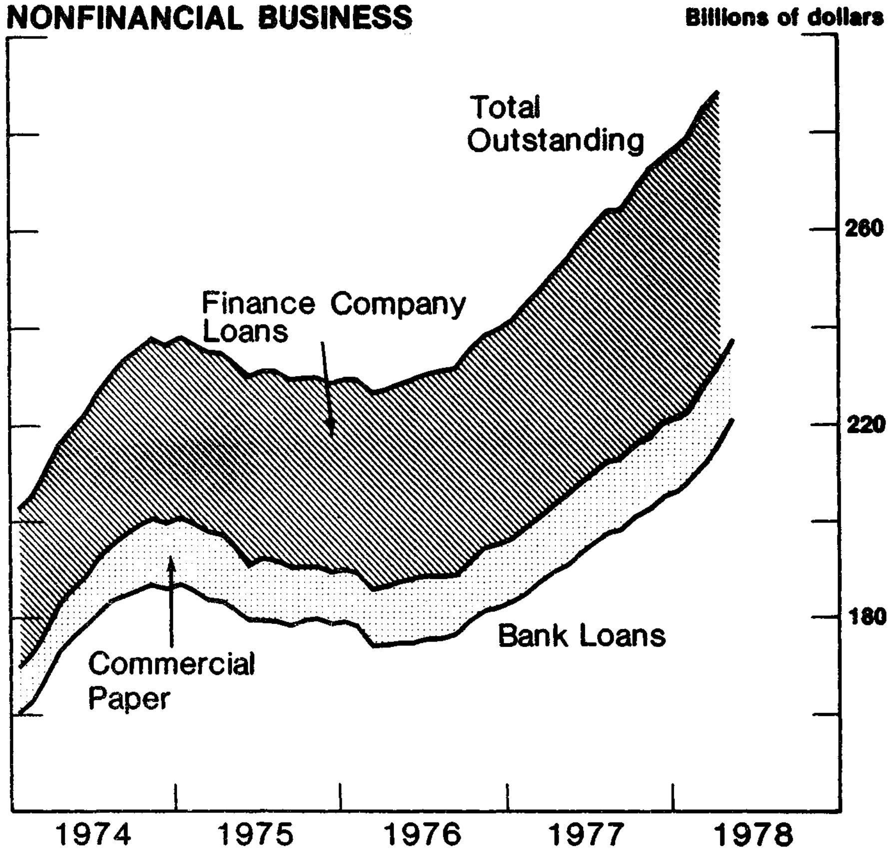
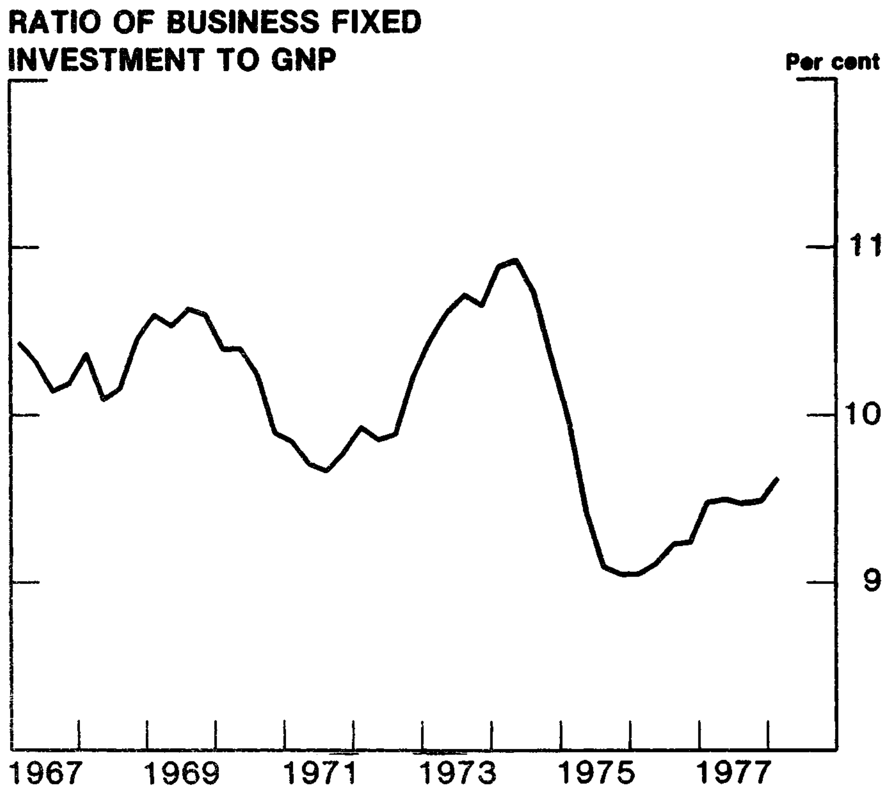
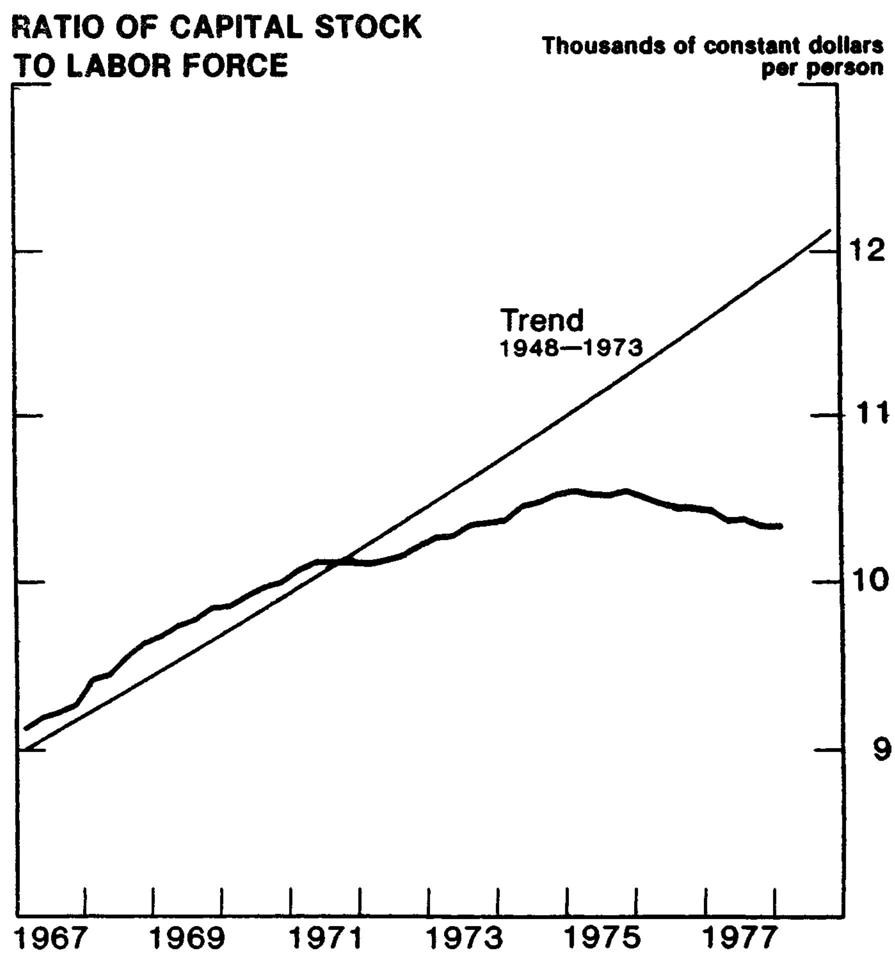


Chart 6



RATIO OF BUSINESS FIXED INVESTMENT TO GNP
Per cent
11
10
9
1967
1969
1971
1973
1975
1977

RATIO OF CAPITAL STOCK TO LABOR FORCE
Thousands of constant dollars per person
Trend
1948—1973
12
11
10
9
1967
1969
1971
1973
1975
1977