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SEMI-ANNUAL REPORT ON MONETARY POLICY

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

July 28, 1978

Mr. Chairman, members of this distinguished Committee, it is a pleasure to meet with you today to present the report of the Federal Reserve on the outlook for the economy and monetary policy.

. ECONOMIC GAINS CONTINUED AT A GOOD PACE INTO FOURTH YEAR OF EXPANSION

The current economic expansion, which began in early 1975, is now into its fourth year. Only one postwar upswing--that beginning in 1961--has lasted significantly longer. Thus, we have had an unusually durable expansion, and it has been well sustained thus far this year, as may be seen in attached Chart 1.

Especially encouraging has been the performance of the labor market. Payrolls have swelled by more than 2 million workers since last December. The over-all unemployment rate has dropped below 6 per cent, and the rate for heads of households is 3.6 per cent. Joblessness among youths and minorities remains disturbingly high, but these groups, too, have experienced appreciably improved employment opportunities in recent months.

. AND ECONOMIC INDICATORS POINT TO FURTHER GROWTH

The willingness of businessmen across the country to hire in such large numbers suggests that they are looking forward to further growth of production. And, indeed, economic indicators generally point in that direction. As may be seen in Chart 2, buying sentiment still is at a high level, and with recent employment gains providing an impetus to income, consumer spending should continue to rise.

In the business sector, cautious inventory management has kept stocks in good balance in most sectors; rising sales are therefore likely to prompt further advances in inventory investment. Various surveys of business intentions--as well as data on equipment orders and construction contracts, shown in Chart 3--suggest moderate increases in capital spending in the months ahead. In addition, our net export balance, which has deteriorated over the past two years, has begun to improve. Imports are likely to rise less rapidly during the next year. At the same time, exports should pick up if activity abroad increases as expected and as the changes in exchange rates that have occurred since last fall improve the competitive position of U.S. goods.

The increase in housing starts last month suggests that construction activity will remain at a high level over the near-term, but it appears likely that building will begin to taper off later this year, partly as a consequence of the firmer conditions prevailing in the mortgage market. And growth in State and local government expenditures probably will remain modest, in light of the increasing pressure for restraint in public spending.

On balance, the various indicators of spending and activity suggest that the current expansion will continue in the year ahead. As an expansion matures, however, growth can be expected to moderate, and I think it is likely that over the next four quarters real GNP will grow by about 3½ to 3¾ per cent. Such a pace should be adequate to keep unemployment from rising; during the second quarter of 1979, the unemployment rate may average 5¾ to 6 per cent.

. INFLATION, HOWEVER, IS A SERIOUS CONCERN

As an expansion continues there is also always the danger that developing imbalances will weaken and ultimately dissipate its forward thrust. The greatest threat to the present expansion lies in accelerating inflation. As indicated in Chart 4, price increases have stepped up sharply so far this year--through May, consumer prices rose at an annual rate in excess of 10 per cent. To be sure, much of this surge is attributable to adverse developments in the volatile agricultural sector, and relief from double-digit food price increases should be forthcoming later this year. But the prices of other goods and services also have been rising briskly recently, and the advance in unit labor costs--a key determinant of price trends--has accelerated. My best guess is that during the four quarters ahead prices in general will rise at an average rate of 7 to 7½ per cent.

With the economy moving into a period of heavy collective bargaining, the intensified inflation we have been experiencing and the greater tautness of labor markets could be reflected in higher wage demands, and if they are met, labor costs would rise even more rapidly. As it is, these costs will be boosted early next year by additional mandated hikes in social security taxes and in the minimum wage. The continued interplay of wage and price rises, coupled with the legislated cost increases, will make it difficult to achieve much relief from underlying inflationary pressures over the next year.

The strong momentum of inflation must be a central consideration for government policy-makers today. If we pursue a course that does not soon contain the forces accelerating the advance of prices, the result will be increasing economic disruption and distortion, ending in all probability in serious recession. Monetary policy has been--and will continue to be--designed to restrain inflation. But monetary policy cannot do the job alone. Placing too great a burden on monetary policy would entail dangers of severe financial dislocation that could have unfortunate longer-run consequences for the domestic and international economies.

. FINANCIAL MARKETS SHOWING INFLATIONARY PRESSURES

Financial markets have already begun to show the strains of inflationary pressures. Debt burdens have grown tremendously as households and also businesses have borrowed to finance desired real outlays at rapidly rising prices. Financial institutions meanwhile have experienced declining liquidity as they have attempted to accommodate heavy loan demands. The most obvious sign of these mounting pressures of supply and demand in credit markets has been the upward path of interest rates since the spring of 1977, shown in Chart 5. The increase of interest rates can be attributed in good part to the diminishing confidence of borrowers and lenders that inflation will slow in the future.

The willingness of households to go heavily into debt at relatively high interest rates in some degree reflects a feeling that it is best to buy now before prices rise still further. This sentiment undoubtedly has been a major factor in the demand for houses throughout the past few years, and it seems to have played an important role in the burst of sales of cars and other consumer durables during the first half of 1978. As may be seen in Chart 6, the volume of consumer and mortgage credit extended in connection with these purchases has been growing rapidly and so has the ratio of debt repayment obligations to disposable personal income; both have reached unprecedented heights. To date, loan delinquency experience has not deteriorated significantly, so households evidently have not encountered serious problems in meeting scheduled payments; however, this situation bears careful watching.

So, too, does the apparently declining level of corporate liquidity. During the past two years profits and other internal funds of businesses have fallen increasingly short of the sums needed for investment in inventories and fixed capital. The result has been a rising volume of borrowing and a declining volume of liquid asset accumulation; balance sheet ratios have been deteriorating since late 1976, as indicated in Chart 7.

On top of these private credit demands have come sizable public demands. State and local governments have issued bonds in record volume during the past couple of years, but these governmental units also have provided funds to credit markets through a record accumulation of financial assets. The same cannot be said for the Federal government. In financing the Federal budget deficit, the Treasury has competed actively with the private sector for credit and has added to the general upward pressure on interest rates.

. . LIQUIDITY OF DEPOSITORY INSTITUTIONS HAS DECLINED

During the early stages of economic recovery, commercial banks and thrift institutions were able readily to satisfy the loan demands of households and businesses while at the same time adding large amounts of Government securities to their portfolios. In the past year, by contrast, there has been a fairly steady decline in liquidity ratios of these institutions. With rising yields on Treasury bills and other market instruments diverting funds from savings and small-denomination time deposits, commercial banks, besides curtailing security acquisitions, have issued a substantial volume of large CDs and other short-term liabilities. Meanwhile, savings and loan associations--the leading home mortgage lenders--have reduced their holdings of Treasury securities and have borrowed heavily from Federal Home Loan Banks and other sources.

. . GROWTH IN M-1 HIGH RELATIVE TO LONG-RUN RANGES, BUT M-2 AND M-3 WITHIN THEM

The Federal Reserve might have attempted to alleviate some of the liquidity pressures in the economy by aggressively providing bank reserves and money. But at best this would have offered no more than a temporary palliative. And it would have set the stage for an explosion of monetary expansion and exacerbated our problem of inflation.

As it is, since early 1977 there has been a rather persistent tendency for growth in the narrow money stock, M-1, to run above the rates the System had projected. Over the past four quarters, for example, M-1--which includes only currency and demand deposits--

increased 7.9 per cent. As shown in Chart 8, this was well above the 4 to 6½ per cent range reported to this Committee a year ago.

Over the same four quarter span, however, the broader monetary aggregates--M-2 and M-3--recorded net increases that were well within their announced ranges. Chart 9 depicts the behavior of M-2, which is M-1 plus time and savings deposits at commercial banks (other than large negotiable CDs). M-3 includes also time and savings deposits at thrift institutions.

The fact that growth rates of M-2 and M-3 remained within their ranges over the past year, while M-1 growth was strong, is attributable to the slowing in expansion of the interest-bearing components of the broader aggregates. A year ago, yields on shorter-term market debt instruments were below those that depository institutions are permitted to pay on savings and small-denomination time deposits. But as market rates rose, they surpassed the regulatory ceilings, prompting many savers to divert funds from deposits to Treasury securities, money market mutual funds, and other higher yielding investments.

. . NEW CERTIFICATES ENHANCE GROWTH OF TIME AND SAVINGS DEPOSITS

To help preserve the competitiveness of depository institutions--and thus to avoid the distortion of credit flows that might occur if these intermediaries were unable to accommodate borrowers who do not have access to open market sources of funds--the Federal regulatory agencies created two new deposit categories, effective

June 1. One is an 8-year time deposit on which banks may pay up to 7¾ per cent and thrift institutions up to 8 per cent. The other is a 6-month, $10,000 minimum balance account whose ceiling is determined by the results of the most recent weekly auction of 6-month Treasury bills. Banks are permitted to pay a rate equal to the average discount yield in the auction, and thrift institutions a quarter percentage point more.

A noticeable pick-up in inflows to savings and small time deposits in June is evidence of the success of depository institutions in exploiting the new certificates. The 6-month floating-ceiling certificate appears to have been quite effective in stemming the outflow of funds into market investments. An estimated $8½ billion of the new instruments were issued in June alone--$6½ billion at thrift institutions--and growth has continued brisk this month.

. NEED TO RESTRAIN INFLATION

The Federal Open Market Committee at its meeting last week considered carefully these recent patterns of monetary expansion, as well as the prospects for the economy, in deciding on the appropriate longer-term ranges for the monetary aggregates. Although, as always, members of the Committee differed somewhat in their appraisal of the outlook, there was a broad consensus that inflationary pressures would remain strong, if not strengthen, in the year ahead. While the recently published 5.7 per cent unemployment rate is not low by historical standards, most analysts agree that the unemployment levels at which inflationary pressures are likely to mount have been raised substantially by compositional changes in the labor force and by the effects of unemployment compensation and other institutional factors on decisions regarding work. Under the circumstances, it is critical that macro-economic policy be conducted most prudently at this juncture to assure that economic expansion continues at an appropriate pace without fueling the already unacceptable intensity of inflationary pressure.

. MONETARY GROWTH RANGES UNCHANGED

Growth ranges for the monetary aggregates selected by the FOMC for the year ending with the second quarter of 1979 are identical to those announced three months ago. The range for M-1 is 4 to 6½ per cent; for M-2, it is 6½ to 9 per cent; and for M-3, 7½ to 10 per cent. The growth range for bank credit, though, was raised to 8½ to 11½ per cent in recognition of the greater share of borrower demands being directed toward banks.

The Committee discussed at some length arguments in favor of raising the upper limit of the range for M-1. A major part of the discussion focused on the question of whether the persistent tendency over recent quarters for M-1 growth on average to overshoot the FOMC's longer-run range represented a fundamental shift in the demand for M-1 relative to GNP that should be accommodated. The Committee concluded that an upward adjustment in the range at this time would be undesirable in light of continuing inflationary pressures. Nonetheless, it was recognized that, in light of the recent behavior of money demand, growth in this aggregate over the year ahead might well be around its upper limit.

Scheduled regulatory changes could lead to a lower measured growth in M-1, however. Once the new regulation allowing automatic transfers of funds from savings to checking accounts goes into effect this coming November, the public can be expected to economize more on demand balances and to shift some funds from demand deposits to savings deposits. Such shifts would tend to reduce growth in M-1 during a transition period in which bank customers adjust to the new service. But the extent to which such a shift in funds will occur over the year ahead is quite uncertain. It will depend on the structure of service charges posted by banks for the new service and on the speed with which the public takes advantage of the added flexibility in cash management. In the transition period, therefore, M-1 will become a less reliable indicator of monetary conditions.

The broader monetary aggregates are not likely to be affected significantly by the automatic transfer regulation. They are expected to grow well within their current ranges in the months ahead, with growth sustained in part by the availability of the new certificate accounts. Thus, a generally ample flow of credit through banks and thrift institutions can be expected.

There are always great uncertainties surrounding monetary projections, but the FOMC believes that these ranges for the four quarters ahead are consistent with further moderate expansion of economic activity. Unfortunately, I cannot report that the Committee expects a diminution of inflationary pressure over the coming year. A reduction in the rate of price advance will require more time if it is to be accomplished in an orderly manner, given the present built-in biases toward inflation in the country.

These biases--regulatory, legislated, and expectational--prevented the Committee from taking a further step at this time toward the lowering of the monetary growth ranges--a process that must be continued over time if the nation is to achieve reasonable price stability. In any event, under current circumstances, continuation of the present growth ranges for the aggregates implies a continued posture of restraint against inflationary pressures and probably involves some additional--but tolerable--liquidity pressure on financial intermediaries.

. . NEED FOR A LONGER RANGE EFFORT TO TREAT STRUCTURAL PROBLEMS

These observations underscore the limitations of monetary policy as the main bulwark against inflation, and the need to mount a broad attack on the economic problems we face. A significant reduction in the Federal budget deficit would be an important first step in reducing inflationary pressures. But a longer range effort to treat the structural problem of inflation also is necessary.

We must re-shape our tax laws to make certain that there are adequate incentives for saving and investment. The nation has for many years now devoted too large a proportion of its production to consumption and too small a share to the expansion and modernization of its industrial plant. As a result, productivity growth has languished, with serious consequences for inflationary trends and our standard of living.

We must take steps as well to bolster our position in international trade and thereby to strengthen the dollar. We should continue to seek freer access to world markets and attempt to make American businessmen more aware of opportunities for sales abroad.

We must seek ways of training and placing those individuals who, because of lack of skills or limited knowledge of employment opportunities, are not readily absorbed into the work force.

And we must remove the impediments to competition, relieve the undue regulatory burdens, and avoid the costly governmental actions that have contributed importantly to inflationary pressures in recent years.

It is important to take strong measures now to curb inflation, and with the continued cooperation of the Administration, the Congress, the Federal Reserve, and the private sectors of the economy, I believe that we can within the next several years establish an economic environment conducive to full employment with price stability.

Chart 1

OUTPUT, EMPLOYMENT, AND UNEMPLOYMENT

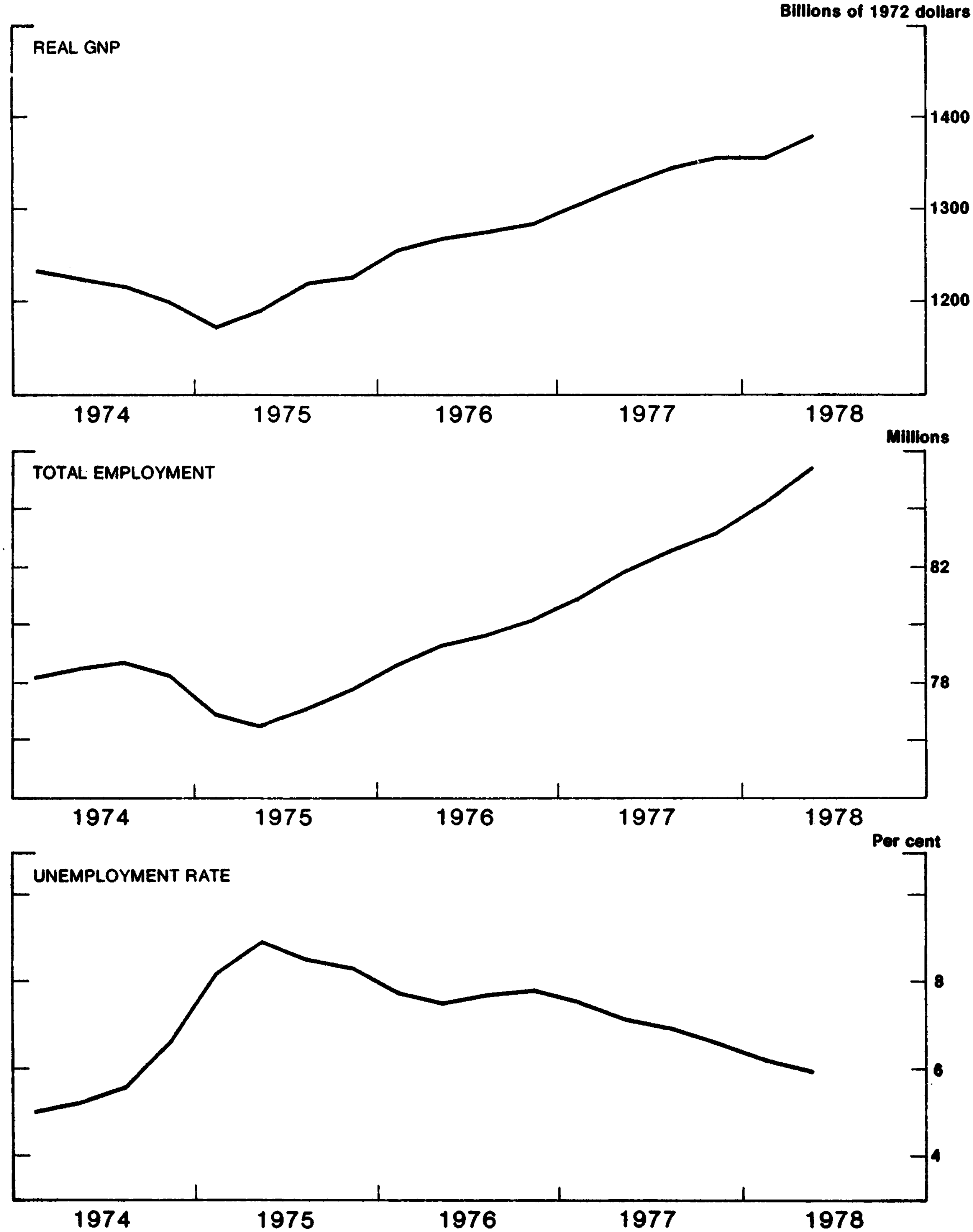
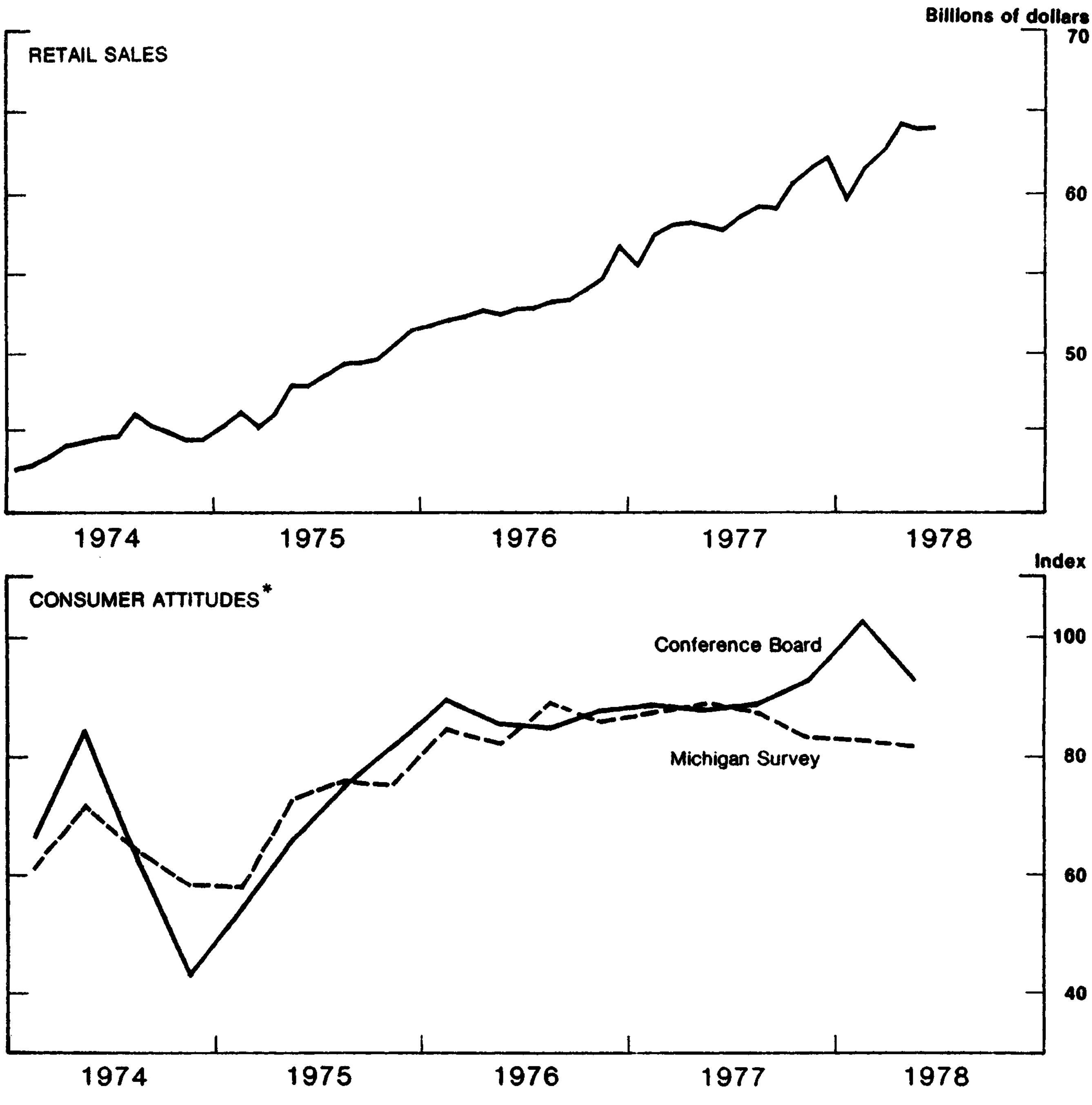


Chart 2

CONSUMER SECTOR ACTIVITY



* Conference Board index of consumer confidence, 1969-70=100.
Michigan survey index of consumer sentiment, 1966 QI=100.

Chart 3

BUSINESS CAPITAL SPENDING ACTIVITY

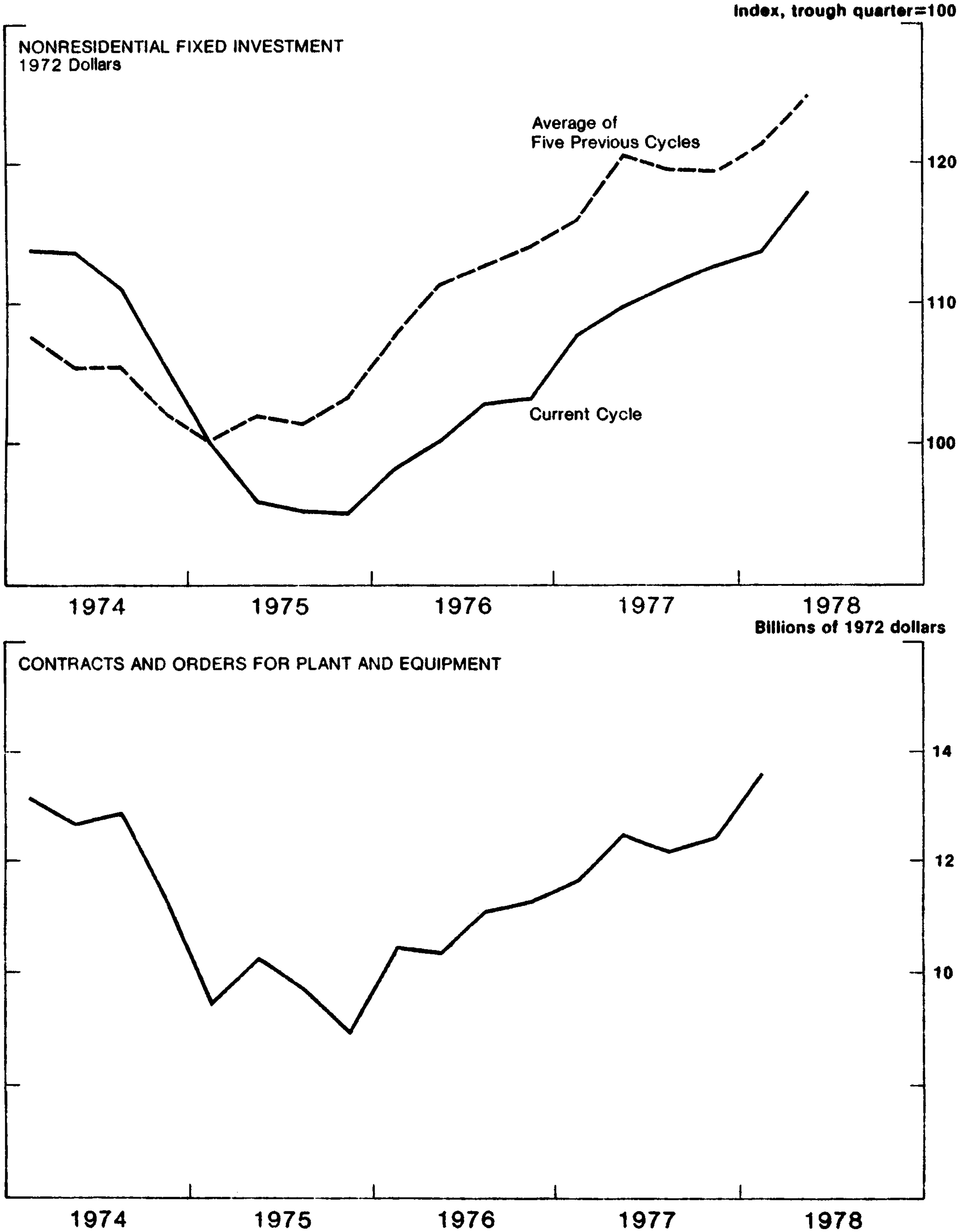


Chart 4

MEASURES OF AGGREGATE INFLATION

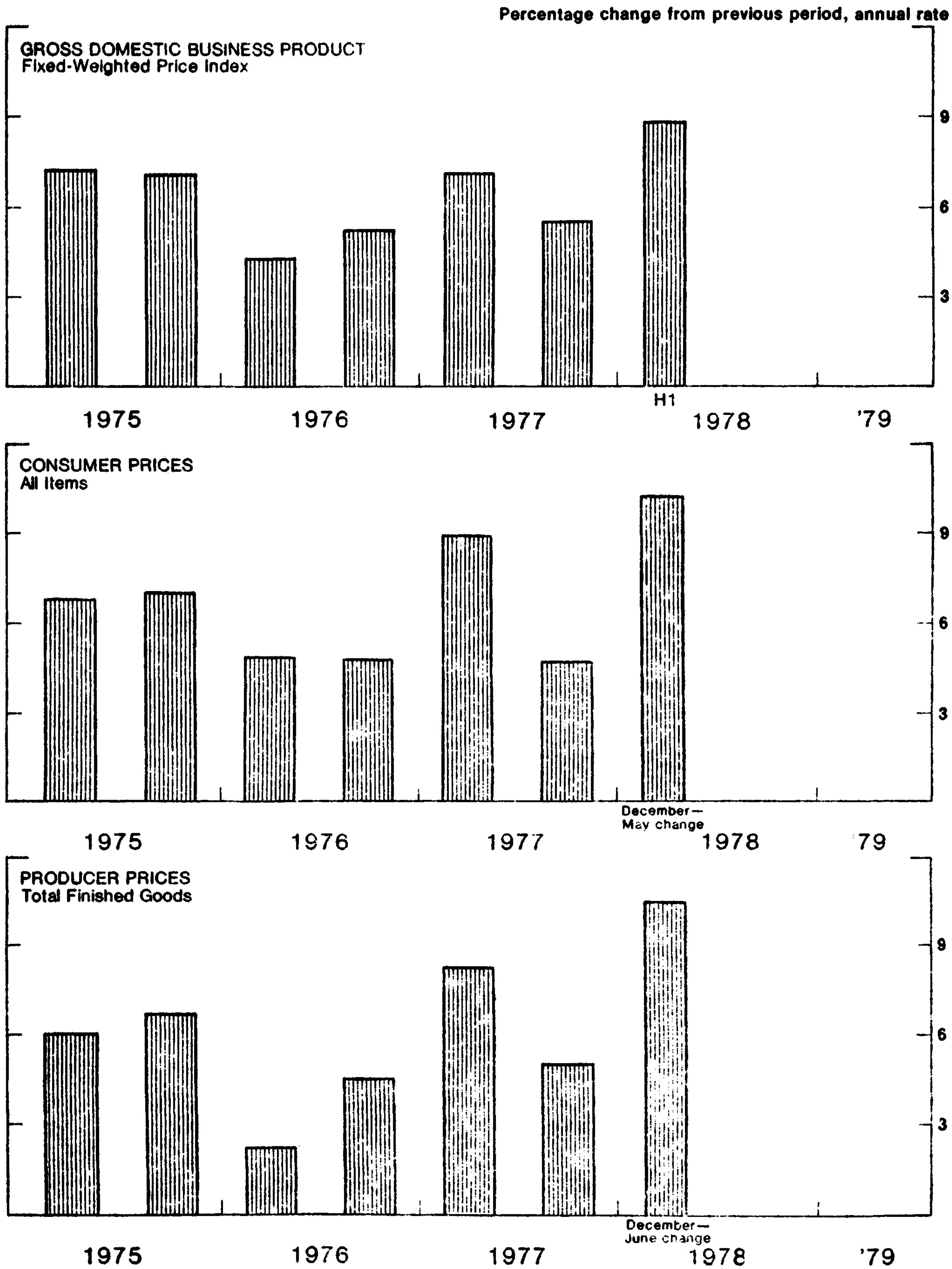
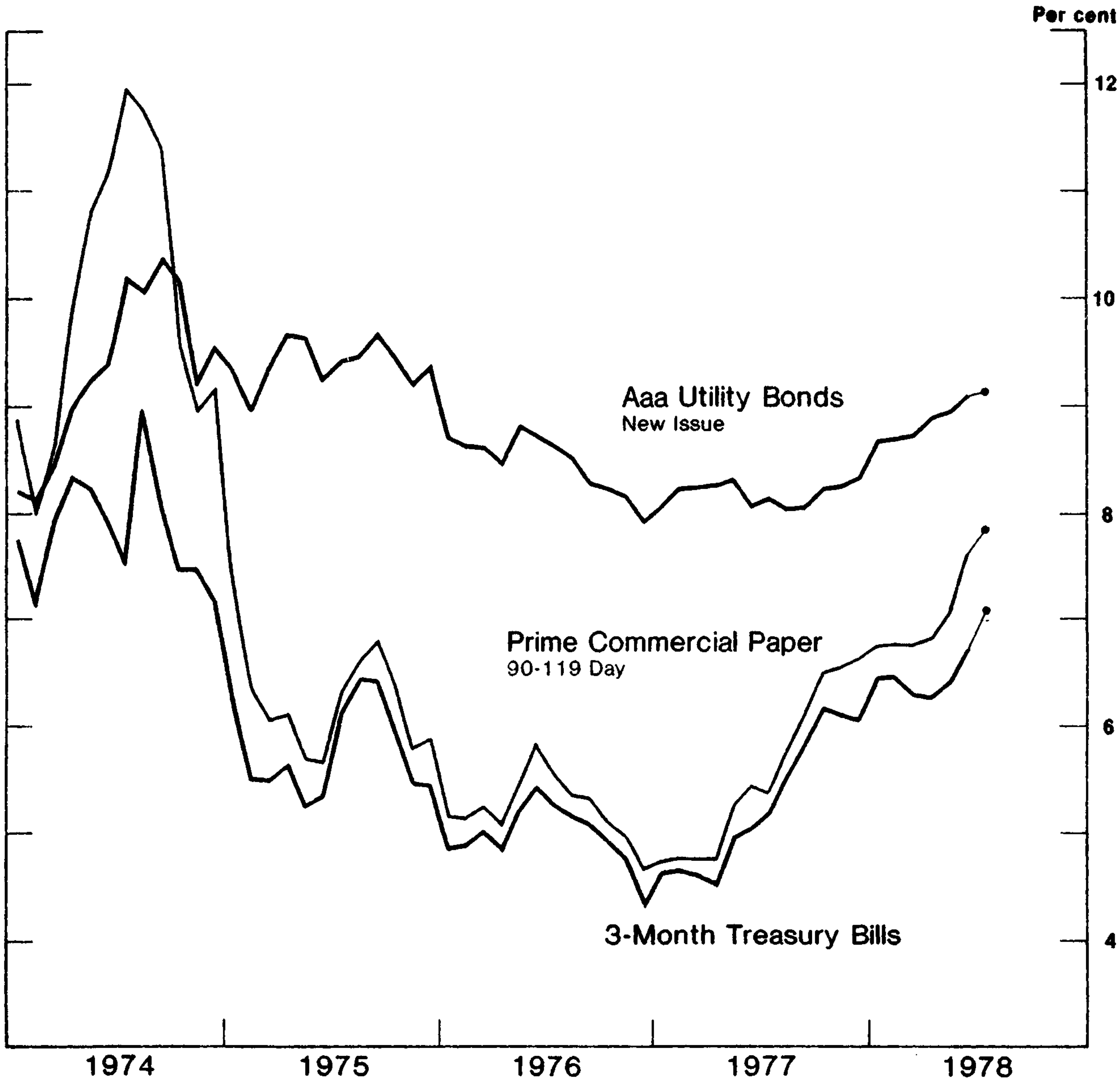


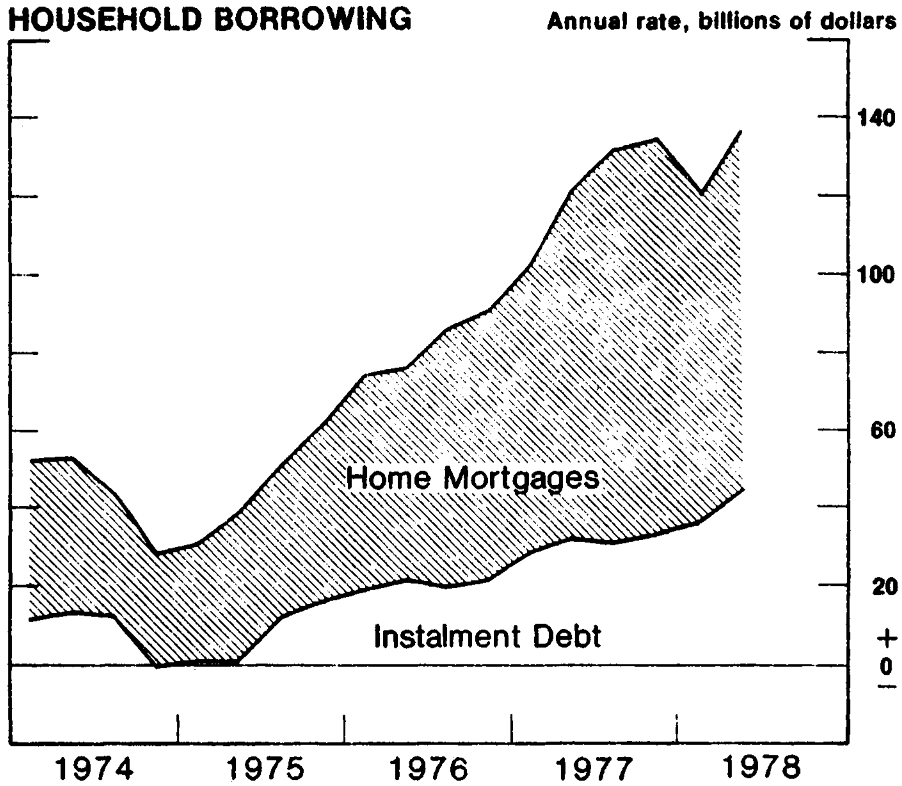
Chart 5

INTEREST RATES



• Week of July 19th

Chart 6


HOUSEHOLD BORROWING
Annual rate, billions of dollars
140
100
60
20
+
0
−
Home Mortgages
Instalment Debt
1974
1975
1976
1977
1978

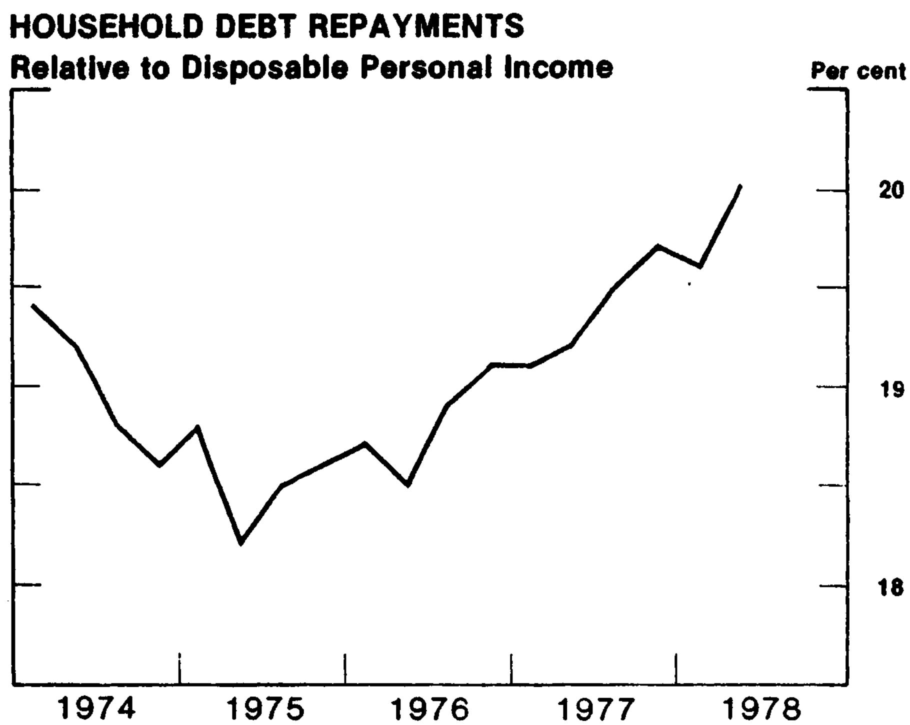

HOUSEHOLD DEBT REPAYMENTS
Relative to Disposable Personal Income
Per cent
20
19
18
1974
1975
1976
1977
1978

Chart 5

RECENTLY ESTABLISHED M-1 GROWTH RANGES AND ACTUAL M-1

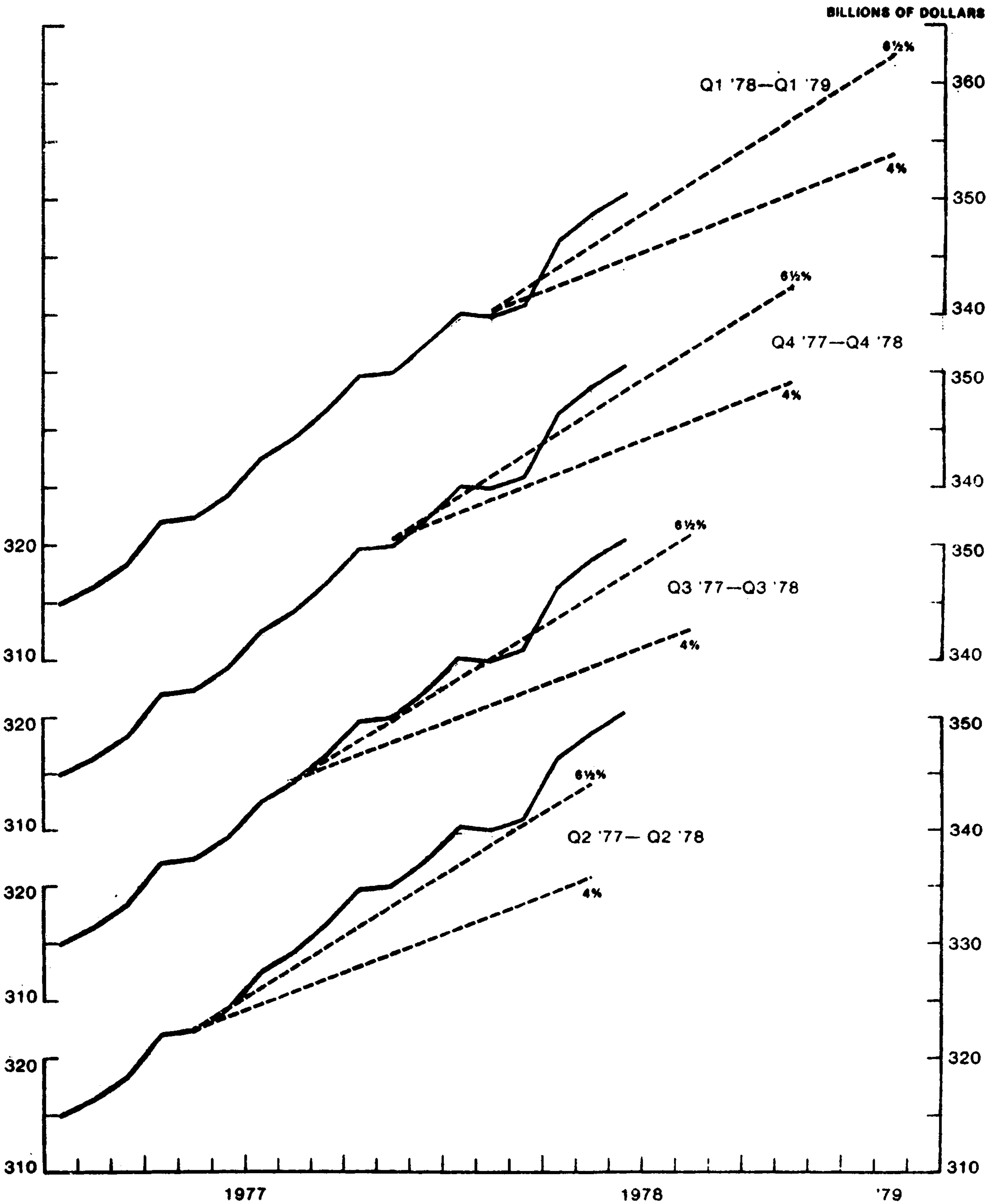
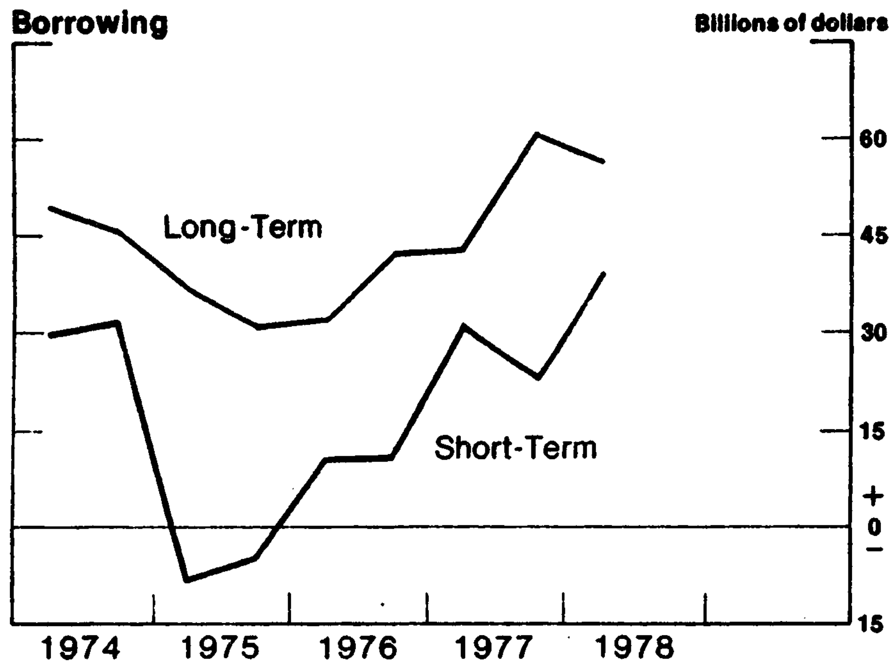


Chart 7

CORPORATE FINANCE



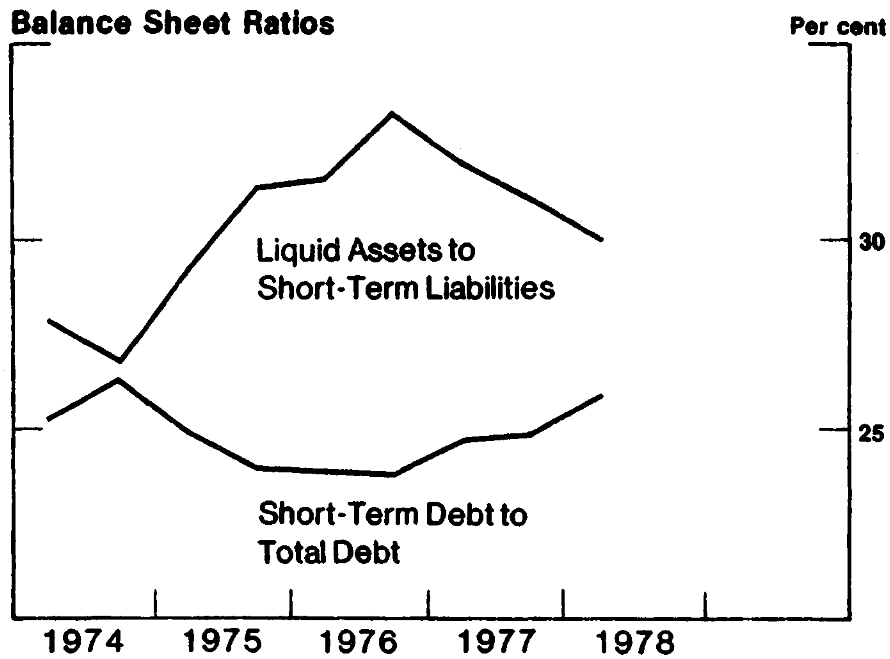


Chart 9

RECENTLY ESTABLISHED M-2 GROWTH RANGES AND ACTUAL M-2