For Release on Delivery
Expected at 10:00 a.m. (E.S.T.)
January 25, 1979

Statement by

G. William Miller

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

House of Representatives

January 25, 1979

Mr. Chairman, members of this distinguished Committee, I am pleased to be able to participate in these important hearings. It is my hope that, by expressing the views of the Federal Reserve on the nation's economic problems and prospects, I can be of some assistance to you as you frame the First Concurrent Budget Resolution for the 1980 fiscal year.

The current economic expansion is nearing its fourth anniversary. This makes it quite venerable in comparison with past cyclical upswings--especially when one exempts from consideration those that have owed their longevity to the stimulus of war spending. More important, it has achieved this ripe age without losing its vitality. Although the growth of activity has slowed in the past year from its earlier very brisk pace, the gains have continued to exceed the trend rise of potential output and have produced sizable increases in employment.

Real GNP advanced 4-1/4 percent over the past four quarters, as compared with the 5-1/2 percent average annual rate of increase during the earlier stages of the expansion. Total employment rose 3.3 million during 1978--an exceptionally large gain but less than the record of the preceding year. As shown in Chart 1, this was enough to cut the overall rate of unemployment almost 1/2 percentage point to 5.9 percent despite continued rapid growth of the labor force.

The progress of the past year has, in fact, appreciably narrowed the margin of unutilized resources in the economy. Utilization rates for industrial capacity have risen, and although by and large they remain below the peaks of some earlier cyclical upswings, there are some areas of tightness. Similarly, in labor markets the overall unemployment rate is still rather high by historical standards, but there is growing evidence of tautness in various sectors, and firms generally are finding it increasingly difficult to hire workers with needed skills. These developments are a normal accompaniment of economic expansion and to date have not reached troublesome dimensions. However, we certainly have arrived at a stage where resource constraints could quickly become a serious problem if aggregate demand were permitted to grow faster than productive capacity.

The importance of this consideration cannot be overstated because inflation is an urgent concern and a clear danger to the health of our economy. Even in the absence of excessive aggregate demand pressures last year, inflation accelerated markedly. As may be seen in Chart 2, the general level of prices rose about 8-3/4 percent, versus 6-1/2 percent in 1977. Special factors such as the influence of poor weather and the beef cycle on farm prices played a role in this disappointing performance, but there was also a broad intensification of price pressures across the economy associated with rising unit labor costs. Pay rates increased somewhat faster, reflecting in part a hike in the Federal minimum wage, and employers were confronted with bigger tabs for social security and unemployment insurance. With productivity virtually unchanged, unit labor costs rose about 9 percent in 1978, 2 percentage points more than in 1977.

The worsening of U.S. price trends was a major cause of the dollar's weakness in foreign exchange markets last year. Although the program announced by the Treasury and the Federal Reserve on November 1 succeeded in strengthening the dollar, its average exchange value against other major currencies, on a trade-weighted basis, has registered a net decline of 15 percent since September 1977. This depreciation in turn is having a significant impact on domestic inflation, by raising import prices and reducing competitive restraints on the prices of domestically produced goods. The effect on the U.S. price level last year probably amounted to about 1 percent, and further inflationary effects will be felt this year and next.

It is quite clear that last year we passed from a phase in the economic cycle when the focus of concern is properly the ensurance of strong aggregate demand to one in which emphasis must be placed on the avoidance of inflationary excesses.

The Federal Reserve had begun to assume a less accommodative stance in 1977, but the movement toward restraint accelerated in 1978. System resistance to inflated demands for money and credit was reflected in a substantial rise in market rates of interest. Yields on short-term market instruments generally rose 3 to 4 percentage points last year, while most long-term rates rose a percentage point or more.

These are sizable increases and they brought many rates close to, and in a few cases slightly above, their 1974 peaks. However, this increase in interest rates did not occasion the wrenching of financial markets that has seriously disrupted economic activity on some past occasions.

There are two reasons for this. One is that current interest rate levels are not extraordinary after allowance is made for the prevailing state of inflationary expectations. Nominal interest costs of 9 or 10 percent would have been a severe deterrent to credit-financed spending in periods when inflation was more subdued; borrowers are much more willing to pay such rates, however, when they expect incomes and prices of goods to rise at paces comparable to those experienced recently.

The second reason that we have avoided what is commonly characterized as a "credit crunch" is the structural changes that have occurred in the nation's financial markets. Among the most noteworthy of these is the action taken by the Federal regulatory agencies last spring to ease the restriction on interest rates that depositary institutions may pay on time accounts. The new 6-month "money-market" certificate--whose ceiling varies weekly with Treasury bill rates--has provided banks and thrift institutions with an instrument that can compete effectively for savings even when interest rates on market securities are relatively high. Thus, as illustrated in Chart 3, we have not seen the disintermediation of loanable funds that might have abruptly curtailed the availability of credit--at any reasonable price--to home buyers and other borrowers who are heavily reliant on the depositary institutions for financing.

This is not to say that rising interest rates have been stripped of their impact on economic developments. The increase in rates last year contributed to a slowing in the growth of the monetary aggregates and to a reduction in aggregate credit flows to the nonfinancial sectors of the economy. In the process, monetary policy worked to moderate the expansion of economic activity.

At the same time that the Federal Reserve was moving in the direction of restraint, Congress and the Administration were adjusting their fiscal plans to take account of the reality of unexpectedly rapid inflation. At this time last year, attention was being focused primarily on an expected need to provide stimulus to the economy in Fiscal Year 1979. The First Concurrent Budget Resolution specified a Federal deficit of almost $60 billion--an increase over FY 1978. Subsequently, when it became evident that economic circumstances had changed, there was a significant shift in the direction of fiscal policy. This Committee and its counterpart in the Senate are to be commended for their timely action in reducing the deficit in the Second Budget Resolution to $39 billion.

The discussions now under way deal, of course, with the 1980 fiscal year. This period--commencing next October--seems quite distant in terms of our ability to project with precision the condition of the economy. We must, however, base our policy judgments on a tentative assessment of the likely trajectories of production, employment, and prices. There is a broad consensus that inflationary pressures are going to remain strong for some time and that governmental policies will have to be designed with containment of those pressures as a high priority. There is considerably less accord regarding prospects for economic activity.

The Federal Reserve does not consider a recession desirable. "Stop-go" patterns of economic growth have discouraged productivity-enhancing investment and brought no lasting relief from inflation. A policy directed at fostering a sustained, though modest, rise in economic activity in the period ahead offers the best hope of achieving progress toward the nation's economic goals.

It is our assessment that conditions do, in fact, favor continued expansion. An examination of available indicators suggests that the economy currently is in reasonably good balance. The final quarter of 1978 was a strong one, with real GNP rising at an annual rate of about 6 percent and sizable gains being posted in employment and income. This momentum, coupled with the tax cut taking effect this month, should impart considerable strength to final demand in the current quarter.

It is to be expected that, as time passes, growth in consumer spending will moderate from its recent exuberant pace. The proportion of disposable personal income devoted to consumption has been exceptionally high of late, and with household debt burdens at record levels, consumers are likely to spend a little less freely in the year ahead. In the business sector, advance indicators of plant and equipment expenditures have given mixed signals. Surveys of spending plans point to somewhat smaller gains in outlays for this year than last, but data on actual orders and contracts have suggested a fairly robust investment demand. On balance, it appears reasonable to expect that capital outlays will continue to rise, with some upward revision in spending plans possible as confidence in the sustainability of expansion is bolstered. Businessmen will likely maintain their cautious policies with respect to inventories, but stocks generally are lean and so there is little present danger of a recession-inducing effort to cut back inventories.

Housing starts will probably begin to taper off soon from the high plateau of the past year, as the rise in mortgage interest rates affects housing demand. The decline in residential construction promises to be moderate by comparison with past building cycles, however, because of the strong underlying demands associated with demographic trends and because credit will remain generally available except, perhaps, where local usury ceilings are a barrier. Government purchases of goods and services probably will post only a small increase in 1979, as the national mood expressed in Proposition 13 and like measures suggests that public spending will not exhibit the buoyancy of past years. Finally, our trade balance should improve markedly, reflecting the impact of relatively faster economic growth abroad and the lagged effects of exchange rate changes on both exports and imports.

In all, real GNP expansion seems likely to persist at a modest pace over the course of 1979. Unemployment could well drift upward in such an environment, but at this time there is no foreseeable development of cumulative imbalances that will cause the economy to turn into recession during this year.

Any rise in unemployment implies social costs that one would wish to avoid. It is most certainly true as well that there are dangers that unanticipated shocks--from international or domestic sources--could cause the economy to slip into recession. But an effort to bolster aggregate demand through more expansive monetary or fiscal policies would be fraught with even greater perils. We simply cannot afford at this juncture to risk an intensification of inflationary pressures. A further acceleration of inflation--or even a significant reduction in confidence here or abroad in the government's commitment to gain control of the general price level--would set in motion forces that almost surely would lead eventually to a serious economic downturn.

The monetary and fiscal actions taken over the past year to slow inflation have only begun to exert their effects. The Administration's wage-price standards and other anti-inflation initiatives can be successful only if they are backed up by macro-economic policies of restraint. We must not despair because an inflation that has been woven into the fabric of the economy over the course of a decade has not been and cannot be brought to a halt within a short interval. This is a time for patience. We must find the courage to adhere for a sustained period to the course of policy we have charted.

The implications for Federal budgetary strategy are, I think, clear. From the standpoint of aggregate demand control, we must continue on a path toward a balanced budget. By moving as promptly in this direction as economic circumstances permit, undue reliance on monetary policy can be avoided and pressures on our financial markets can be minimized. The reduction in Federal credit demands associated with a smaller deficit would release financial resources to the private sector. The dimensions of the Treasury's presence in the credit markets during recent years are inadequately recognized. In addition to the massive unified budget deficits that have been recorded year after year, the government has had to finance a growing range of off-budget activities. As may be seen in Chart 4, the Federal off-budget agencies ran up a $10 billion deficit in FY 1978, and it appears that the figure for the current fiscal year will be at least as large. The consequences of this for Treasury borrowing are indicated in Chart 5. Since the beginning of this decade, the outstanding Treasury debt has much more than doubled, absorbing billions of dollars of credit that could have been used productively in the private sector.

Our chances of solving the problem of inflation would also be enhanced if we can slow the growth of Federal spending and thereby reduce the size of the government sector in the economy. This would do much to improve the climate for private capital formation. The modification of our tax structure to encourage saving and investment would have a similar salutary effect.

Our nation has paid a heavy price for its having given inadequate attention to the need for business investment. Our capital stock has not grown as rapidly as our labor force in recent years, and this has played a major role in the poor performance of productivity. Over the past five years, annual gains in output per hour in the nonfarm business sector have averaged less than 1 percent as compared to 1-1/2 percent in the preceding five years--and 2-3/4 percent during the first two decades of the postwar period. This slowdown has retarded the rise in living standards and has aggravated our inflation problem through its adverse impact on unit labor costs. We should set our sights on achieving substantially higher levels of business investment in the years ahead.

The budgetary policies I have described imply a period of austerity. During this period, resources would be diverted from private consumption, and, at the Federal level, new spending programs may have to be delayed and existing programs re-examined to ensure that they are meeting social needs effectively and economically. I believe that the American people are prepared to make this sacrifice in order to win the battle against inflation. They recognize that inflation is eating away at the foundations of our economic structure and imposing a cruel toll on those in our society who can least afford it. It is incumbent upon those of us in government to respond with prudent and realistic policies.

Chart 1

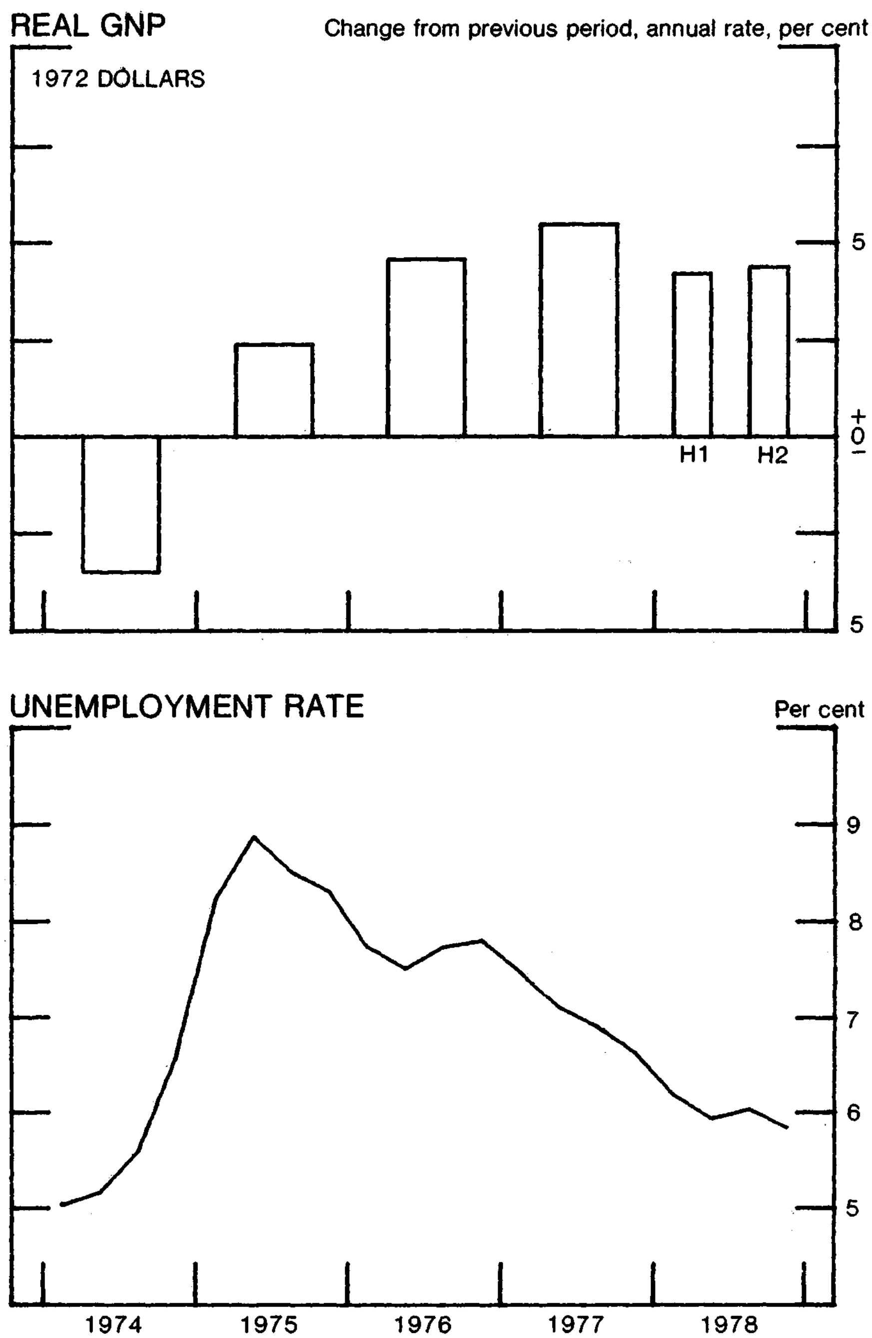

REAL GNP
Change from previous period, annual rate, per cent
1972 DOLLARS
5
+
0
−
5
H1
H2
UNEMPLOYMENT RATE
Per cent
9
8
7
6
5
1974
1975
1976
1977
1978

Chart 2

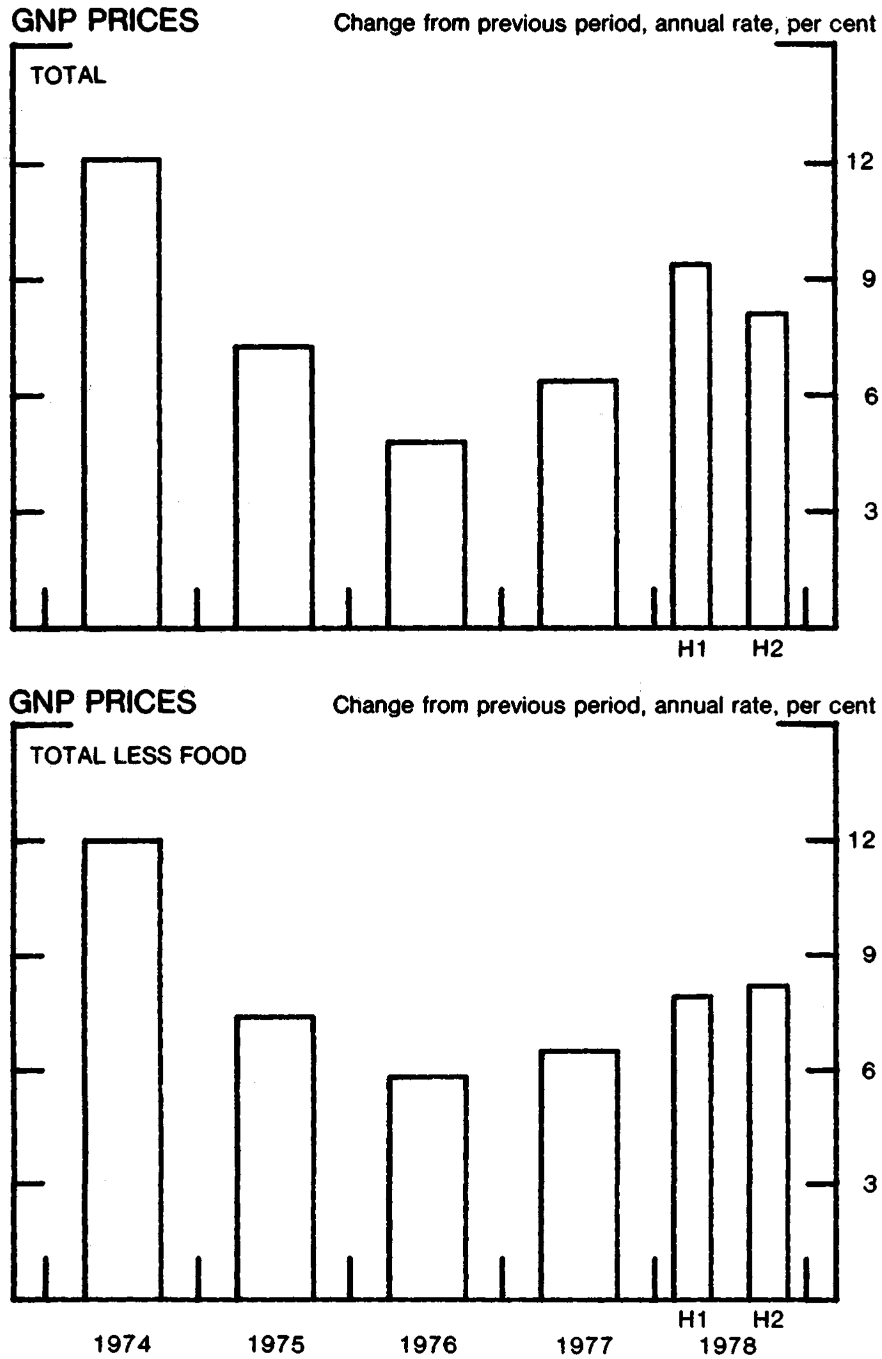
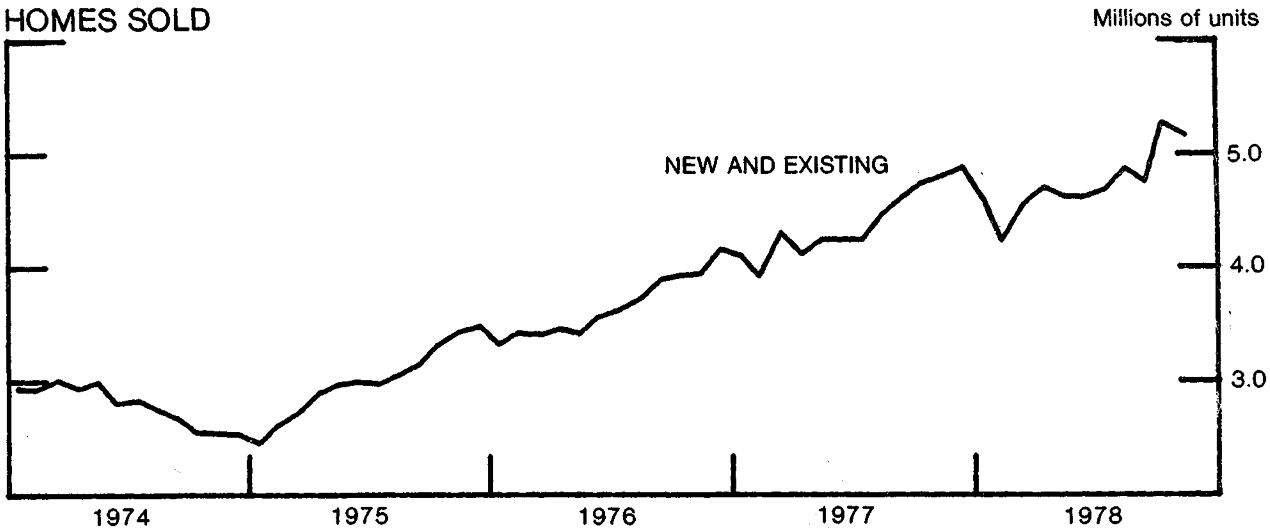
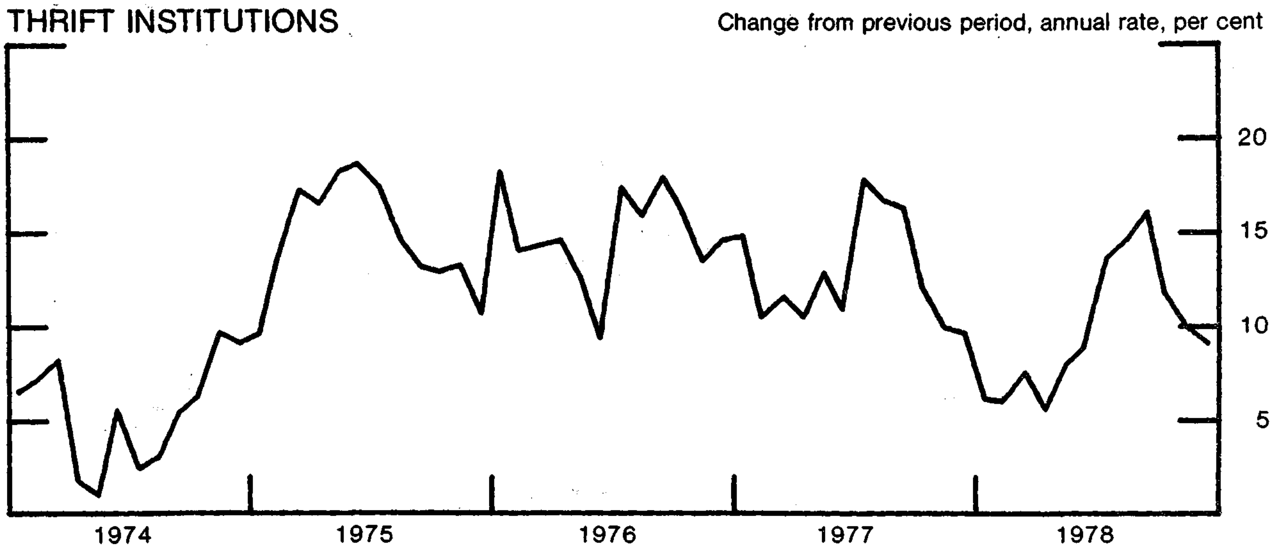

GNP PRICES
Change from previous period, annual rate, per cent
TOTAL
12
9
6
3
H1
H2
GNP PRICES
Change from previous period, annual rate, per cent
TOTAL LESS FOOD
12
9
6
3
H1
H2
1974
1975
1976
1977
1978

Chart 3

HOMES SOLD



DEPOSIT GROWTH AT
THRIFT INSTITUTIONS



OUTSTANDING COMMITMENTS AT
SAVINGS AND LOAN ASSOCIATIONS

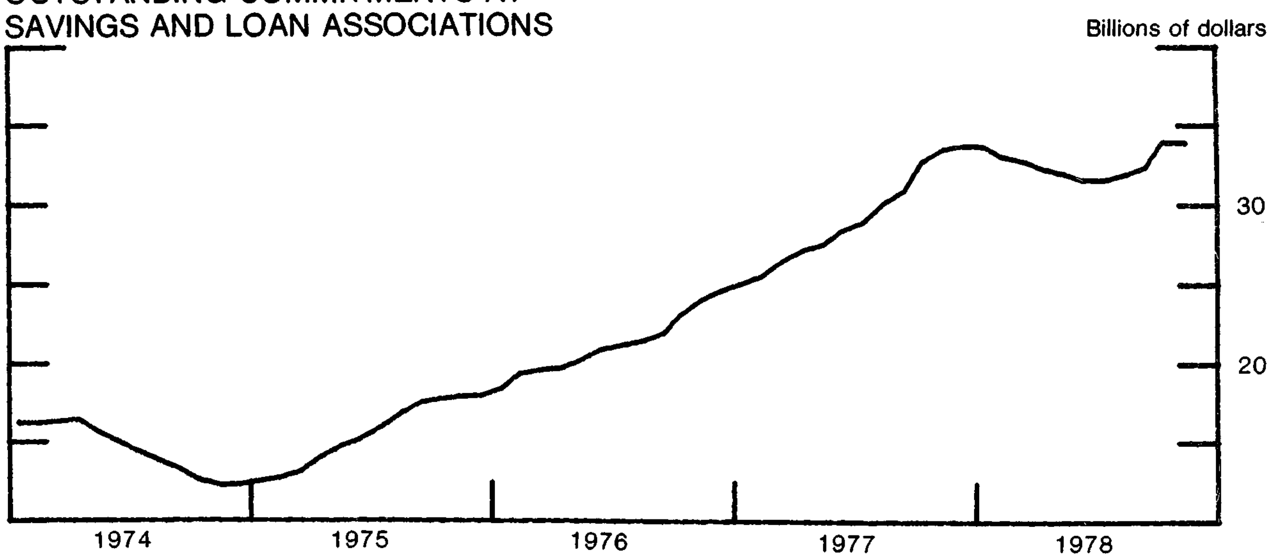
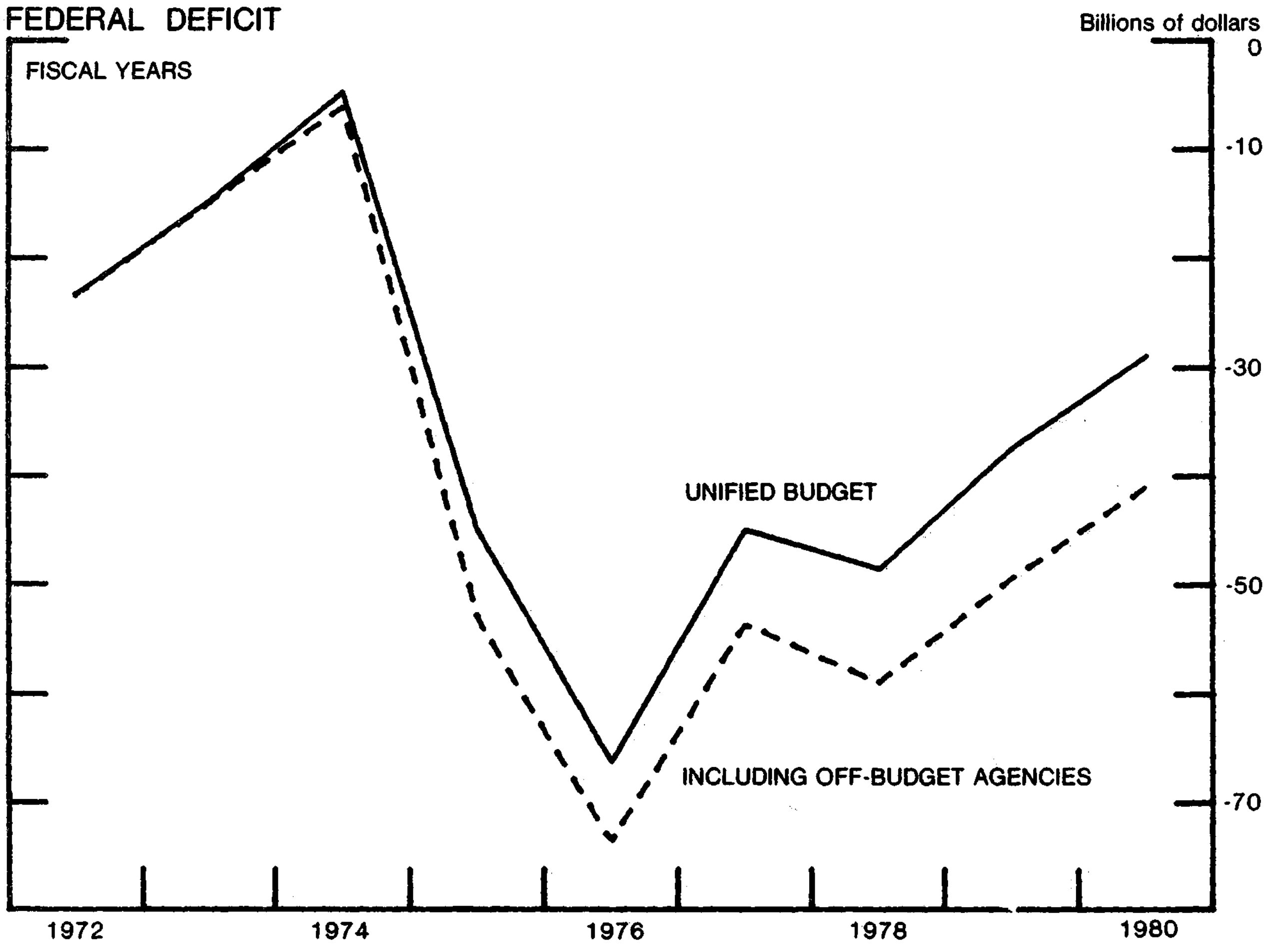
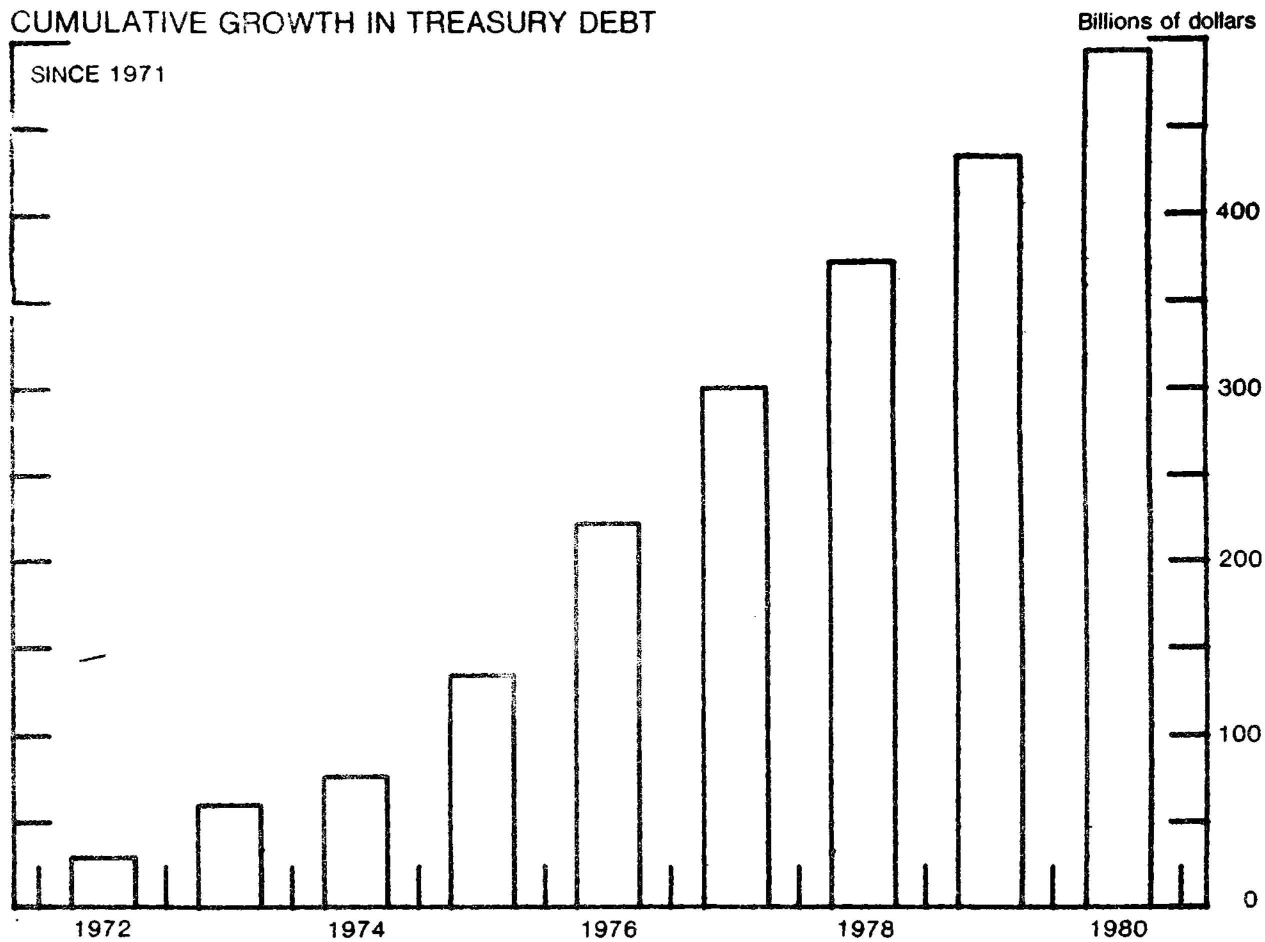


Chart 4



NOTE: Projections for 1979 and 1980 are from The Budget of the U.S. Government, 1980.

Chart 5



NOTE: Projections for 1979 and 1980 are from The Budget of the U.S. Government, 1980.