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Statement by

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before the

Joint Economic Committee

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I appreciate the opportunity to meet with this Committee once again to present the views of the Board of Governors on the condition of our national economy.

Our overall economic performance during the past year has left much to be desired. Unemployment rose to more than 6 per cent of the civilian labor force by year end. Idle industrial capacity increased. Business profits deteriorated further. The price level continued to rise sharply. Our balance of payments remained in an unsatisfactory condition. These frustrations and disappointments cannot be overlooked; but they also must not be allowed to blind us to the progress that our nation has been making toward the restoration of its economic health.

Underneath the surface of aggregate economic activity, major changes took place during 1970, and they have been--on the whole--in harmony with the aspirations of the Congress and the American people. Thus, the defense sector of our economy has continued to shrink, with employment in this sector--when the reduction of the armed forces is counted in--declining three-quarters of a million during the past year. Also, the protracted investment boom in business fixed capital--whose continuance would have necessitated a major retrenchment later on--has tapered off. Meanwhile, the homebuilding industry has in recent months been experiencing a great upsurge of activity. And our trade surplus--which had plummeted from 1965 to 1969--began to recover as our exports rose relative to imports. These several developments have imparted better balance to our national use of resources, and thereby promise to contribute to economic and social progress.

Another highly significant development of the past year was a dramatic change in business attitudes toward the control of costs. As product markets became more competitive and costs continued to mount, business managers in increasing numbers finally recognized that their profit margins, which had been gradually eroding since 1965, would drop sharply further unless ways were found to improve efficiency substantially. Vigorous efforts to eliminate loose and wasteful practices resulted by the second quarter of 1970 in a renewed increase of output per manhour, ending a stagnation which had lasted nearly two years. The rate of advance in unit labor costs therefore moderated last year, even though wage rates continued to rise at an undiminished pace.

The new attitude toward cost controls had its counterpart in business financing. The speculative mood of the latter years of the 1960's had given rise to loose financing practices that posed a threat to financial stability. This became abundantly evident last summer, when conditions approaching crisis prevailed for a time in some of our financial markets, notably in the commercial paper market.

These developments served as a pointed reminder to the business and financial community that canons of sound finance are still relevant in our times. Chastened by experience, many firms have of late been reducing their exposure to risk by funding short-term debt or by enlarging equity cushions. In turn, many lenders have been screening loan applications with greater care and upgrading their investment portfolios. Households, too, have been placing greater emphasis on liquidity and safety in the management of their financial assets. The prospects for maintaining order and stability in financial markets during the years immediately ahead have thus been enhanced.

The processes at work in our financial markets during the past year have strengthened the prospects for recovery in economic activity this year. The liquidity of commercial banks and of other financial institutions has improved markedly. Credit has become more readily available to prospective homebuyers, State and local governments, and small businesses, as well as to the larger industrial and commercial enterprises. Interest rates have tumbled.

Indeed, the decline in long-term interest rates since the middle of 1970 has been the largest and most rapid of the postwar period. Even interest rates on consumer loans and mortgage interest rates--which often display downward inflexibility--have declined during the past several months. And the decline of interest rates brought, of course, welcome relief to a badly depressed bond market.

As bond prices rose and cost-cutting by business firms continued, investors began to look forward expectantly to renewed expansion in business activity and earnings. Interest in common stocks therefore revived, and share prices--particularly of "blue chips"--have staged a spirited recovery. With the financial underpinnings of the economy improved, housing starts have already risen briskly and State and local construction projects--delayed earlier by tightness in credit markets--are being financed more readily and at much lower cost.

Thus, when we look beneath the surface of aggregative measures of economic behavior, we find that a large part of the foundation needed for an enduring prosperity was rebuilt during the past year. Let me turn next, therefore, to the role that monetary policies played in fostering this achievement.

Monetary policies during 1970 at first sought to create an environment in which progress could be made in unwinding from the inflationary excesses of the past, while providing sufficient stimulus to prevent economic weaknesses from cumulating. As the year advanced, the Federal Reserve gave increasing attention to liquidity problems and to the need for establishing the financial basis for a resumption of economic growth.

At the beginning of 1970, as this Committee knows, monetary restraint reached its peak of intensity. The monetary policy pursued during the preceding year had become increasingly restrictive because of the urgent need to curb inflation. During the latter half of 1969, the narrowly defined money supply--that is, currency plus demand deposits--had grown by an annual rate of only 1 per cent, while time deposits of commercial banks actually declined sharply. Bank liquidity was at a very low level; heavy deposit withdrawals were draining funds from mutual savings banks and savings and loan associations; the supply of mortgage credit had shrunk severely; many State and local governments were unable to arrange financing of their construction projects; even some of the largest business enterprises were having difficulty in satisfying their financing needs; interest rates were at or soaring towards historic peaks; and confidence in financial markets was waning.

As I have already indicated, conditions in our money and capital markets have since then changed dramatically. Confidence in financial markets and institutions has been restored; liquidity positions have improved; credit has become both cheaper and more readily available to a broad spectrum of borrowers; and all this was accomplished with a moderate--and I believe a prudent--rate of monetary expansion.

Last year, the narrowly defined money supply rose by 5-1/2 per cent. This is by no means a low rate of growth by historical standards. Indeed, it was exceeded in only four years during the postwar period--1946, 1951, 1967, and 1968, each a year of intense inflation. However, when the economy is sluggish, and when very unusual demands for liquidity are encountered, as they were in 1970, a rate of monetary expansion that is appreciably above the historical average is not inappropriate.

Broader measures of the money supply indicate even more clearly the rather expansive course of monetary policy during 1970. For example, if the concept of the money supply is broadened to include commercial bank time deposits other than large-denomination certificates of deposit (CD's), we find that growth in money balances during 1970 was at an 8 per cent rate--accelerating from 6 per cent in the first half to more than 10 per cent in the second.

An assessment of recent monetary policy requires, of course, attention to numerous financial variables besides the money supply, whether defined narrowly or broadly. By the second half of 1970, the increase in total funds available for lending and investing by commercial banks had risen to an annual rate of 10 per cent. Of course, this high rate of expansion partly reflected some rechanneling of borrowing from financial markets to banks after the ceiling rates of interest that banks could pay on short-term CD's were suspended. Allowing for this factor, the increase in available bank funds was still far above the growth of demand for bank loans. Consequently, banks added substantially to their holdings of short-term Treasury securities, and became aggressive buyers of State and local government bonds. They also took steps to encourage additional borrowing by bank customers. Commitments of funds to the mortgage market rose, and growth in real estate loans picked up towards the close of the year. The prime rate of interest on bank loans was reduced in a series of steps from 8-1/2 per cent at the beginning of last year to 5-3/4 per cent presently. Other lending policies too were relaxed, as banks began actively to seek out prospective loan customers.

The effects of these easier monetary policies gradually spread from the banking system to financial institutions at large. At life insurance companies, the drain of investable funds through policy loans decreased over the course of the year, encouraging larger commitments to corporate borrowers. At nonbank thrift institutions, the rate of inflow of deposits rose by the final quarter of last year to levels not seen since the early 1960's--except for a brief period in 1967. Exceptionally high rates of deposit inflow have continued in recent weeks. Indeed, with the supply of mortgage money temporarily outrunning the demand, some institutions find themselves unable to acquire the volume of real estate loans they desire.

These are the indications, I believe, that the monetary policies pursued last year have created the financial conditions needed for a sustained expansion of production and employment. Underlying economic trends have been obscured in recent months by the effects of the prolonged auto strike. Nevertheless, some major economic series suggest that a general recovery of business activity may already be under way. For example, stock prices have been rising briskly for a number of months, as I noted earlier. The increase in residential building activity that began last spring has gathered momentum. New orders for durable goods rose in December, and the ratio of inventories to unfilled orders for durable goods declined for the first time since April 1969. In January, initial claims for unemployment insurance fell somewhat further; the length of the factory workweek increased for the third time in four months; industrial production rose again; and the demand for business loans at commercial banks strengthened measurably.

These indicators suggest that either a real recovery in production and employment is actually under way or that such a development is likely to occur in the near future. A review of trends in several of the major categories of spending points to the same general conclusion.

Let us consider first the principal economic sectors that may display weakness in 1971. Defense spending is one of these. Judging by the January budget message, the outlook is for little change in outlays for defense in the year ahead, which would imply some decline after allowance for price increases. Other Federal expenditures, however, will be rising substantially in the course of the year, thereby adding to the disposable income of consumers and strengthening the financial position of State and local governments.

Business capital spending is also likely to remain sluggish, at least during the early months of this year. Thus far, the recovery since last spring in new orders for capital equipment has been modest, and surveys of business investment plans do not suggest an early upswing in outlays for plant and equipment. Nevertheless, it would not be surprising to see some strengthening in business spending for equipment as 1971 progresses--the encouragement coming in part from the recent liberalization of depreciation allowances.

In contrast to the relative weakness in the defense and business capital sectors, outlays for State and local construction and for residential building should rise vigorously this year. With housing vacancies at a very low level, the decline of mortgage interest rates spreading, and the likelihood of overall economic recovery high and rising, the expansion in the home-building industry should continue; housing starts in the fourth quarter were at the highest level since the early 1950's. We can be reasonably confident also that a substantial revival in State and local government capital outlays will occur this year, although--as this Committee well knows--many muncipalities are facing serious shortages of funds. These financial difficulties may be relieved by Federal grants, and in any event they are much less likely to limit capital spending than the operating programs of State and local governments.

Changes in the rate of inventory investment typically play a strategic role in the course of a business recovery. At present, ratios of factory stocks to sales and to unfilled orders are still quite high in many durable goods lines. This, however, is characteristic of the early stages of recovery. A pickup in the tempo of economic activity in the months ahead would encourage businesses to increase inventories in anticipation of a rising trend of sales. I would not rule out the possibility that a rise in the rate of inventory accumulation will contribute materially to increased production and employment this year.

Ultimately, the shape of business conditions during 1971 will depend on what happens to spending in the largest sector of our economy--the consumer sector. For many months, the mood of the average consumer has been cautious, if not pessimistic. The personal savings rate has remained high, and consumer liquid assets have been built up at an unusually rapid rate. No one can foretell how soon this mood will change.

The caution of the American consumer is due in part to greater awareness of the hazards of unemployment. But a more important factor may well be the steady erosion of the real value of his income and his savings through inflation. Since he sees no effective way to hedge against inflation, the consumer seems to respond to rising prices by increasing his current rate of savings in an effort to stretch the pay-check far enough to cover tomorrow's higher living costs. The consumer's lack of confidence is thereby communicated to the business community. For when consumer buying patterns are weak, businessmen often lack the confidence to undertake new ventures to expand markets, introduce new products, or increase productive facilities.

The strength of economic expansion during and beyond 1971 will depend, in my judgment, principally upon our success in restoring the confidence of consumers and businesses in their own and the nation's economic future. Restoration of confidence must be a central objective of economic stabilization policies in 1971.

In the present economic environment, there can be no doubt that monetary and fiscal policies must for a time remain stimulative, as they have been recently. The degree of stimulus coming from the budgetary policy announced by the President is, it seems to me, broadly consonant with the needs of an economy operating well below full employment.

However, if past experience is any guide, actual expenditures might run above those currently projected, and we must therefore be extremely careful not to let Federal expenditures again get out of control. To do so would seriously undermine confidence at a time when we need to do everything in our power to increase confidence.

An appropriate monetary policy for the months ahead probably would require sufficient growth in the reserves of the commercial banking system to foster continued expansion in monetary and credit aggregates at rates above their long-term averages.

Let me assure you, in this regard, that the slowdown of the past few months in the growth rate of the narrowly defined money supply does not reflect a change in Federal Reserve policy. Provision of bank reserves through open market operations during this period has, in fact, been quite generous. The public, however, has chosen to hold additions to its deposit balances in the form of time accounts rather than demand deposits. Most recently, in fact, growth of a more broadly defined money supply--that is, currency plus demand deposits plus commercial bank time deposits other than large CD's--has actually accelerated to an average annual rate of over 12 per cent during the months of December and January. Short-term variations of this kind in the public's preferences for demand and time deposits are not uncommon.

We do not understand them fully, but we should not let them distort judgment of the course of monetary policy.

Continuation of a monetary policy that is consistent with economic recovery will enlarge the supply of available funds, and borrowers should therefore find it easier to obtain credit. Later this year we might perhaps see interest rates somewhat lower than they are now--particularly on mortgages and longer-term securities. In areas where monetary policy affects credit conditions with a rather long lag--for example, in the nation's smaller communities and in the credit terms available to smaller businesses and consumers--we could look forward to seeing more evidence of the effects of monetary stimulation as the year progresses. And as easier monetary and credit conditions work their way through the financial system, we could anticipate cumulative effects on spending, on production, and on employment.

Financial developments of this kind might have adverse effects, in the short run, on our balance of payments--in the form, particularly, of a net outflow of interest-sensitive funds. The extent of this outflow may be limited, however, by measures such as those taken recently. These involved discouraging the repayment of Euro-dollar borrowings by our banks to their branches abroad, or the recapture of these funds through the sale of special securities to the foreign branches.

More fundamentally, I am convinced that policies which promise a healthy and prosperous domestic economy are essential to long-run improvement in our international payments position. To be competitive in international markets, our economy must operate with a maximum of efficiency and a minimum of inflation. A prosperous domestic economy will encourage American citizens to invest more at home rather than abroad. Moreover, some forms of capital inflow will be stimulated by economic recovery. Thus, the rate at which foreigners invest here by buying corporate securities or establishing affiliates has risen since the middle of last year, and might well increase further this year.

In view of the interest rate differentials that have recently emerged between the United States and other countries, as well as because of the persistence of inflation, closer attention will need to be given by our government to the balance of payments. I do not expect, however, that these considerations will prevent us from pursuing the course of monetary policy needed to achieve a good recovery in employment and production in 1971, especially if further progress is made in moderating inflationary pressures.

Past experience supplies some broad indications of what the appropriate course of monetary policy might be. We know, for example, that while a high rate of growth of the narrowly defined money supply may well be appropriate for brief periods, rates of increase above the 5 to 6 per cent range--if continued for a long period of time--have typically intensified inflationary pressures. We also know that periods of strong cyclical recovery in production and employment in the postwar period have typically been financed with relatively modest increases in the money supply. In such periods, the income velocity of money--that is, the ratio of GNP to the money stock--has risen substantially, reflecting the more intensive use of cash balances by the public. Following each of the past three postwar recessions, for example, the income velocity of money rose during the first four quarters of recovery by amounts ranging from 5-1/2 per cent to nearly 7 per cent.

We cannot, of course, be confident that history will repeat itself. If the income velocity of money does not rise in 1971 in line with past cyclical patterns, then relatively larger supplies of money and credit may be needed. One of the great virtues of monetary policy is its flexibility, so that adjustments can be made rapidly to unexpected developments. The Federal Reserve will not stand idly by and let the American economy stagnate for want of money and credit. But we also intend to guard against the confusion, which sometimes exists even in intellectual circles, between a shortage of confidence to use abundantly available money and credit, on the one hand, and an actual shortage of money and credit, on the other.

I can assure this Committee that the Federal Reserve will continue to supply the money and credit needed for healthy economic expansion. But I also wish to reaffirm the assurance that I gave to this Committee and the nation a year ago--namely, that the Federal Reserve will not become the architects of a new wave of inflation. We know that the effects of monetary policy on aggregate demand and on prices are spread over relatively long periods of time. We are well aware, therefore, that an excessive rate of monetary expansion now could destroy our nation's chances of bringing about a gradual but lasting control over inflationary forces.

We recognize also, as do an increasing number of students around the world, that the problems of economic stabilization policy currently plaguing us cannot be solved by monetary policy alone, nor by a combination of monetary and fiscal policies. Monetary and fiscal tools can cope readily with inflation arising from excess aggregate demand. But they are ill suited to dealing with a rising price level that stems from rising costs at a time of rising unemployment and excess capacity.

During the past year, despite an increase in unemployment of 2 million persons, we have once again witnessed advances in wage rates substantially above the growth of productivity. In industries such as retail trade and finance, wage rate increases have slowed somewhat. In others, such as manufacturing and construction, the rate of advance in average hourly earnings has not diminished. Wage settlements granted in major collective bargaining agreements during 1970 were, in fact, considerably larger on the average than in the previous year. For the first year of the new contracts, they averaged 8 per cent in manufacturing and 18 per cent in the construction industry.

There have been earlier instances in our history when price increases have continued for a time despite weakness in business activity. But, as far as I know, we have never before experienced a rate of inflation of 5 per cent or higher while the unemployment rate was rising to recession levels. Continuation of this situation much longer would, I am afraid, sap the confidence of the American people in the capacity of our government and in the viability of our market system.

We are thus confronted with what is, practically speaking, a new problem. A recovery in economic activity appears to be getting under way at a time when the rate of inflation is still exceptionally high.

The stimulative thrust of present monetary and fiscal policies is needed to assure the resumption of economic growth and a reduction of unemployment. But unless we find ways to curb the advance of costs and prices, policies that stimulate aggregate demand run the grave risk of releasing fresh forces of inflation.

In view of this new problem, it is the considered judgment of the Federal Reserve Board that, under present conditions, monetary and fiscal policies need to be supplemented with an incomes policy--that is to say, with measures that aim to improve the workings of our labor and product markets so that upward pressures on costs and prices will be reduced.

The Administration has already taken significant steps in this direction. Public attention has been called pointedly to areas in which wage and price changes are threatening the success of our battle against inflation. Restrictions on the supply of oil have been relaxed. Part of the recent increase in prices of structural steel has been rolled back as a result of governmental intervention. And the President has clearly conveyed to the construction industry that the government will no longer tolerate the runaway labor costs that are destroying construction jobs and depriving so many of our families of the opportunity to buy a home at a price they can afford to pay.

These steps have put our nation's business and labor leaders on notice that the government recognizes the character of the present inflationary problem, and that it is serious in its intent to find a cure. If I read the national mood correctly, widespread public support now exists for vigorous efforts to bring wage settlements and prices in our major industries within more reasonable bounds. Such efforts should bolster consumer and business confidence, and thus contribute materially to getting our economy to move forward once again.

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