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Statement by

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before the

Joint Economic Committee

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I am pleased to report to this Committee once again the views of the Federal Reserve Board on the state of the economy.

Since my appearance before this Committee in February, evidence has accumulated of a significant strengthening in the pace of economic expansion. The output of our Nation's factories and mines has increased rapidly since last fall and now exceeds the previous peak rate in September 1969.

Advancing levels of production and sales have resulted in a larger demand for labor by manufacturing plants, distributive firms, service establishments, and other places of business. Total employment since June of last year has risen by 3 million and the length of the workweek has generally increased.

The improvement of labor markets has encouraged substantial numbers of women and younger workers to enter the labor force. The ranks of job seekers have also been swelled by a sizable reduction in the Armed Forces. As a consequence, unemployment has remained high despite better job opportunities. Last month, however, unemployment did show a heartening decline.

A major source of the quickening tempo of economic activity has been the recovery in business capital formation. Confidence of the business community was bolstered by the governmental measures adopted last year to moderate inflation and to stimulate employment and output. With incentives to invest strengthened, contracts for business construction and orders for machinery and equipment have been rising vigorously.

Higher residential construction has also been a stimulating factor. New housing starts have declined somewhat from the level reached early in 1972, but the effects of the pronounced rise in new housing starts last year are still ramifying. Sales of furniture and appliances, for example, have been soaring this year.

Consumer buying generally has been on a marked uptrend since the late summer of 1971. Spendable incomes of consumers have risen steadily and substantially, as employment has increased and the workweek has lengthened. After more than 5 years of stagnation, average weekly earnings of production workers have increased significantly in real terms since last summer. Confidence in the economic outlook has improved, and consumers are now borrowing at record rates to buy new autos and other durable goods.

In short, as we see the economic scene, the current expansion is now exhibiting the characteristics typical of cyclical recoveries. A strong revival of output in the durable goods trades is under way, employment is rising rapidly, and more and more branches of production are being caught up in the rising trend of activity.

There is good reason to expect this cumulative process of business expansion to continue on into 1973. Inventory accumulation should provide an upward thrust in the months immediately ahead. Stocks have fallen to low levels in relation to sales, and it appears that a pick-up in inventory building is already in process. Business investment in fixed capital should continue to be a major expansive factor, since new orders and contracts for plant and equipment have

been moving strongly upward for some time. If these categories of business spending rise briskly, as now seems likely, growth rates of employment and earnings will remain high. Disposable income will also gain from a rise in social security benefits this fall and sizable tax refunds next spring. With consumers in a more optimistic mood, these additions to purchasing power should stimulate demand further.

Thus, when I consider the recent course of economic activity and the prospects for the near-term future, I find reason for optimism. The expansion in real output and employment has remained orderly and well balanced. Most major sectors appear to be poised for a further rise in activity. And it seems likely that unemployment will diminish as real output continues to rise.

Progress has also been made in moderating the rate of increase in wages and prices. Over the first half of this year, average hourly earnings in the private nonfarm economy rose at an annual rate of about 5-1/4 per cent, compared with 6-3/4 per cent during the first 7 months of 1971. The control program has evidently had a salutary effect, although competitive forces may also have served to dampen the rise in wage rates.

Price indexes too indicate some reduction in the rate of inflation. A comprehensive measure of price performance--the fixed-weight index of prices of all private goods and services in the gross national product--rose over the first three quarters of last year at an annual rate of about 4.5 per cent. In the three most recent quarters, the rate of increase has receded to about 3 per cent.

Other price indexes also show improvement. Thus, consumer prices since last August have increased at an annual rate of 2.7 per cent, compared with 3.8 per cent in the first 7 months of 1971. In the last 4 months, the annual rate of increase averaged about 2 per cent.

The need for further progress in curbing inflationary pressures remains great, however, particularly in view of potential developments in 1973. Next year, collective bargaining agreements covering large numbers of workers will be reopened in major industries. The negotiations will take place in a climate of improving labor markets and against the backdrop of a substantial increase in consumer prices over the past several years. If wage rate increases should accelerate, pressures on unit costs of production would intensify. And business firms would probably take advantage of receptive product markets to pass on cost increases to customers.

Greater success in our efforts to moderate inflation is therefore vital. If costs are to be stabilized, the wage guidelines--which now permit increases in wage rates well above long-term productivity gains--will need to be lowered. But any such wage development will necessitate measures to assure workers that their real earnings will not be eroded by continuing increases in consumer prices.

A tighter rein on inflation is needed not only to protect the incomes and savings of our people; it is needed also to restore equilibrium in our international accounts. Indeed, I seriously doubt whether this external objective can be achieved without a stable price level. The Smithsonian realignment of exchange rates last December

laid the basis for a substantial improvement in our competitive position. But that potential will be dissipated if appreciable increases in domestic costs and prices continue.

Our international accounts are still seriously out of balance. Imports this year have increased substantially further, and while exports have also risen, our trade deficit has deepened. Such a development is not unusual in the months immediately following a currency depreciation, and the more advanced stage of our economic recovery relative to that of our major trading partners has undoubtedly been an aggravating factor. With economic conditions abroad again improving, the demand for our exports should rise more vigorously over the near term. Past experience suggests, however, that 2 or 3 years may need to elapse before the full benefit of last December's exchange rate realignment is realized.

The over-all balance of payments was in substantial deficit during the first quarter. But beginning in mid-March, the over-all balance became more favorable, due principally to short-term capital inflows. Indeed, we actually experienced a balance of payments surplus between mid-March and June 23, when the British pound was floated.

In the weeks immediately following the British decision, exchange markets around the world experienced renewed turmoil, and a sizable shift of dollars into European central banks occurred. Most recently, however, order has been re-established on the foreign exchanges. The renewal of market confidence is due in no small measure to the intervention in the exchange markets by the Federal Reserve in collaboration with the Treasury.

The recent disturbances of exchange markets provide a clear warning. If repetitive monetary crises are to be avoided and an environment conducive to healthy expansion of foreign trade and investment is to be preserved, international negotiations on monetary reform must begin promptly. The recent disturbances are also a warning that turmoil in international financial markets may continue until the United States and its major trading partners find ways to rid their economies of the inflationary sickness that is plaguing us all.

Let me turn next to the course that our Nation's monetary and fiscal policies must pursue to offer hope of solving our inflation problem, and at the same time facilitate growth in production and employment.

Typically, expansions in economic activity are accompanied by pronounced pressures in credit markets, reflecting larger credit demands as well as more stringent monetary policies. Thus far, this expansion has been rather free from such pressures. Inflows of savings deposits to nonbank thrift institutions--though below earlier peaks--remain abundant, and these funds are being used actively in mortgage lending. Commercial banks, besides extending substantial amounts of credit to businesses and consumers this year, have been able to acquire a record volume of mortgages and to supply a major part of the funds raised in credit markets by state and local governments. And although interest rates on short-term securities have risen from their lows early this year, long-term rates of interest

have changed very little. Actually, interest rates on practically all classes of loans and securities--including mortgages--are distinctly below their July 1971 levels.

A major reason for the relative stability of interest rates was the substantial reduction in the size of the Federal deficit for fiscal 1972 from earlier expectations. Moderation in business credit demands was also a contributing factor. Retained earnings of corporations were augmented by the rise in business profits, the release of funds by the investment tax credit and accelerated depreciation, and the 4 per cent ceiling on dividends imposed by the Committee on Interest and Dividends. Businesses were thus in a good position to finance their needs for increased investment spending and working capital from internal sources.

Monetary policy over this past year also contributed to stability in credit markets. The Federal Reserve pursued a moderate course of monetary expansion, so that fears of a new wave of inflationary pressures would not be generated. But the Federal Reserve also saw to it that the economic recovery would not suffer for want of money or credit.

The moderate course of monetary policy is evidenced by the major monetary aggregates. During the 12 months ending in June, the narrowly defined money supply (currency plus demand deposits) increased by 5 per cent, or less than the increase in the Nation's real output.. The money supply defined more broadly, so as to include time deposits other than large-denomination certificates of deposit, rose faster as consumers built up liquid assets by adding to their time and savings accounts.

As this Committee knows, rates of monetary expansion have recently varied considerably from one quarter to the next. The effects of such variations on economic activity can easily be exaggerated. Last fall, for example, growth in money balances slowed sharply, and concern was voiced in some quarters that the economic expansion would falter. Actually, there was no shortage of money or credit at that time. The abundant supply provided in the first half of last year was still there to meet the need of consumers and businesses. In fact, the slowdown served a useful function. For it assured the public that there was no intention to open the monetary spigot in a reckless effort to stimulate expansion, while wages and prices were being held in check with direct controls.

The Board recognizes, however, that fluctuations in growth rates of money and bank credit have at times gone beyond our intentions. To deal with this problem, techniques of implementing monetary policy have recently been altered in ways that might permit us to minimize undesired variations.

Early this year, the Federal Open Market Committee decided that the pursuit of its monetary goals might be aided by focusing less heavily on the Federal funds rate as an operating target and instead giving more weight to the desired growth of the bank reserves held against private deposits. This change in operating procedure did not, of course, mean that money and capital market developments would be disregarded. It merely meant that, in the Committee's judgment, greater emphasis could be placed on the reserves needed to attain the desired growth rates of the monetary aggregates, while still giving

attention to interest rates and other dimensions of financial markets. Monetary developments since January seem to confirm that judgment, but more time will be needed to evaluate properly the new operating techniques.

At present, the Federal Reserve is in a favorable position to continue pursuing a path of moderate monetary growth, for economic expansion thus far has been orderly and supplies of real resources are still ample. And if, as seems likely, private credit demands advance at a temperate pace, interest rates near current levels could continue to prevail in the months immediately ahead.

Whether or to what degree this desirable outcome is realized will depend heavily on the state of the Federal budget. At the time of the midyear budget review, the deficit projected for fiscal 1973 was \$27 billion. The recent passage of the social security bill has raised that figure appreciably. Supplements to defense spending not allowed for in the midyear budget review may add further to the deficit. And there will be a temporary but potentially dangerous bulge in the deficit next spring, when large refunds of over-withheld taxes will add to disposable income. This concentrated fiscal stimulus could have unfortunate consequences for prices.

I recognize that deficits are difficult to avoid when tax revenues fall below the levels that would be produced by an economy operating at full employment. But in fiscal 1973 the deficit may be growing at a time when the economy is expanding briskly and the margins of unused capacity are narrowing. Such a development would

add explosive fuel to the fires of inflation. I therefore see no escape from the conclusion that the time has come when the Congress must put our fiscal house in order.

We stand at a crossroads in our fiscal arrangements. Many of our citizens are alarmed by the increasing share of their incomes that is taken away by Federal, State, and local taxes. Meanwhile, Federal expenditures have been rising at a rate well above the growth rate of our national income and product. The propensity to spend more than we are prepared to finance through taxes is becoming deep-seated and ominous. An early end to Federal deficits is not now in sight. Numerous Federal programs have a huge growth of expenditures built into them and there are proposals presently before the Congress that would raise expenditures by vast amounts in coming years.

The fundamental problem, therefore, is how to regain control over Federal expenditures. I do not think this can be accomplished without departing from our traditional methods of budgetary management.

I have long been an advocate of zero-base budgeting -- a procedure that would require careful scrutiny by the congressional appropriations committees of the full expenditure requested for every Government program, rather than just the increase in expenditures. Such a procedure would help to weed out programs whose social usefulness has diminished or ended. It would take considerable time, however, to reform budgetary procedures along these lines even if the Congress were ready to adopt it.

To obtain immediate results, other steps are needed. Recently, a bipartisan group of Congressmen advanced a proposal that would prohibit consideration of any appropriation bills in the House of Representatives until the House had approved a resolution containing a comprehensive Federal budget. The proposal also would require a two-thirds majority vote for any appropriation bill exceeding the provisions of the over-all budget resolution. This is a highly constructive suggestion. I hope the Congress will give it careful study and at the same time consider the desirability of establishing a Joint Committee of the Congress on Revenues and Expenditures.

Another proposal that could produce immediate beneficial results has already been studied by many members of the Congress-- namely, the President's recommendation for a legislative ceiling on this year's budget expenditures. I strongly support this recommendation in the hope that the ceiling would be a rigid one, that it would admit of no escape hatches whatever, and that it would apply both to the Executive and to the Congress.

Re-establishment of order in our Federal finances has become a critical need in our Nation's struggle against inflation. In the Board's judgment an enduring prosperity cannot be achieved unless this need is attended to promptly and courageously by the Congress.

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