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Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

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I welcome this opportunity to discuss the condition of the national economy and to convey the Federal Reserve's views on monetary policy.

The performance of our economy during the past two years has been disappointing. We have suffered the most damaging peacetime inflation in our nation's history, a critical shortage of energy supplies, and the deepest decline in business activity since the end of World War II. Similar problems have plagued practically every industrial country in the world.

The recession of 1974-75 in our country will, I believe, be viewed by economic historians as the culminating phase of a long cycle in economic activity that began in 1961. During the industrial phase of the long upswing -- from 1961 through 1964 -- productivity grew rapidly, prices remained quite stable, and real wages and profits kept advancing. During the next ten years -- from 1965 through 1974 -- the strength of the American economy was gradually undermined. A succession of interrelated, partly overlapping, waves of speculation occurred -- first in merging business enterprises and organizing conglomerates; next in the stock market; then in the real estate market; and finally in the markets for industrial materials and other commodities. During

this long speculative phase, productivity languished and expansion in the physical volume of output decelerated, while the pace of inflation kept quickening -- mainly, but by no means entirely, in response to the lax financial practices of the Federal Government. Bad harvests, extraordinary increases in the price of oil, another devaluation of the dollar, and the coincidence of booming business around the world played their part in the inflationary process during 1973 and 1974.

As a result of these myriad developments, seeds of recession were sown across the economy. Inflation led to a burgeoning of credit demands, both public and private, and interest rates soared to unprecedented heights. Rising consumer prices eroded the purchasing power of workers' incomes and savings. The sharp rise in the price of oil caused a diversion of purchasing power to foreign suppliers. Corporate profits diminished -- a fact that businessmen were slow to recognize because of accounting techniques that failed to take account of inflation. Construction of new dwellings and office buildings proceeded on a scale that greatly exceeded underlying demand. And inventories of commodities piled up, often at a very rapid

pace, as businessmen reacted to fears of shortages and of accelerating price increases.

By the spring of 1973, signs of faltering in the pace of economic expansion had already emerged. Homebuilding began to turn down, and so too did sales of mobile homes, new autos, and other big-ticket consumer items. A declining trend in the physical volume of other goods purchased by consumers soon followed. These developments, however, were largely overlooked by a business community caught up in the euphoria created by inflation. New orders flowing to manufacturers continued to rise, order backlogs generally increased, and stockpiles of materials and other commodities mounted. By the summer of 1974, the physical volume of business inventories was already higher in relation to sales than at any time since the Korean War. The stage was thus set for a significant economic adjustment.

The recession that ensued has cut deeply into the nation's economic life. Between September 1974 and May of this year, industrial output fell by 12-1/2 per cent. Total employment dropped by 2-1/2 million from its peak in October 1974 to a low in March of this year. And the rate of unemployment rose

from under 5 per cent in late 1973 to perhaps 9 per cent at the present time.

In view of the serious economic imbalances caused by inflation, the recession has been performing a painful, but unavoidable, function. Corrective forces have been released and they have helped lay the basis for a renewal of sound economic expansion.

Thus, business competition is now much keener than it was a year or two ago. Business managers are also devoting more attention to cost control and improvements in efficiency. Prices of industrial raw materials have fallen substantially. Price increases at later stages of processing have also become less extensive. The rise of the general price level has therefore slowed -- from an annual rate of about 12 to 14 per cent late last year to about half that rate recently. Increases of wage rates, moreover, have moderated, although they still are much higher than the long-run rate of improvement in productivity. Meanwhile, stock prices -- a significant indicator of the state of confidence -- have risen substantially.

The slowdown in the pace of inflation and the revived stock market have bolstered the confidence of the general

public. Early this year, as price concessions on autos and other items became common, consumer purchases -- especially of durable goods -- began to pick up. In fact, consumer expenditures during the first quarter rose in real terms as well as in dollars. This strengthening continued in the second quarter, as spendable incomes of consumers were augmented -- first by tax rebate checks, later by extra social security checks. With consumer buying expanding and production declining, the efforts of business firms to work down their excess stocks have been remarkably successful. Inventories of most consumer goods now seem to be in rather good balance with sales.

Significant progress has also been made in improving the financial position of business firms. Corporations have issued exceptionally large amounts of longer-term securities this year, and they have used much of the proceeds to repay short-term debt or to acquire liquid assets. The liquidity position of consumers has likewise been strengthened; instalment debts to banks and other lenders have been paid down, and many millions of individuals have added substantially to their savings deposits and other liquid assets.

Financial institutions, too, have improved their financial condition. Commercial banks have taken advantage of the reduced demand for business and consumer loans to repay their borrowings from Federal Reserve Banks, to reduce their reliance on volatile sources of funds, and to rebuild liquid assets. In their turn, savings and loan associations and mutual savings banks reduced their indebtedness and enlarged their holdings of Treasury securities and other liquid assets, thus laying the basis for a renewed expansion of mortgage lending in recent months.

These self-corrective forces have been aided powerfully by fiscal and monetary policies that sought to cushion the effects of economic adversity, moderate recessionary forces, and provide some stimulus to economic recovery. I need not dwell on the fiscal measures that have been adopted to combat recessionary forces; these measures have already been widely discussed. Let me note merely that I believe the Congress acted wisely in providing only a temporary fiscal stimulus through the Tax Reduction Act of 1975. The confidence of our citizens in the nation's economic future has been bolstered by evidence that responsible members of both the executive and legislative branches of our government are seeking ways to stimulate recovery without releasing a new wave of inflation.

This principle has also guided monetary policy. Last summer, as signs of weakening in economic activity multiplied, the Federal Reserve began taking steps to increase the availability of money and credit. Open market operations were oriented toward a more liberal provision of reserves to the banking system; later, these actions were reinforced by several reductions in the discount rate and in reserve requirements.

During the fall and winter months the demand for credit by businesses and consumers weakened on account of the recession, and commercial banks used the more abundant supply of reserves to repay their indebtedness to the Federal Reserve. Growth in M_1 , that is, currency plus demand deposits, was therefore slow to reflect the easing of monetary policy. We at the Federal Reserve were concerned about this development, but we refused to run the risk of releasing fresh inflationary forces and rekindling inflationary expectations. In any event, broader monetary aggregates displayed a more vigorous response to our easing actions. For example, flows of individual savings into commercial banks and thrift institutions began to pick up in the fourth quarter of 1974, and by the first quarter of this year, these deposits were expanding at a seasonally adjusted annual rate of over 13 per cent. In fact,

recent rates of growth of the monetary aggregates have been generally higher than during comparable periods of earlier postwar recessions.

The efforts of the Federal Reserve to ease credit conditions, together with the weakening of private credit demands, resulted in a sharp decline of short-term rates of interest. The Federal funds rate -- that is, the interest rate banks pay when borrowing reserves from one another -- fell from a high of 13-1/2 per cent last summer to about 5-1/4 per cent in early June. The commercial paper rate declined from over 12 per cent last July to a low of about 5-1/2 per cent. And the prime rate of interest on bank loans to businesses fell from 12 per cent to a low of 7 per cent.

In the markets for long-term securities, interest rates also declined, although much less than short-term rates. Of course, long-term rates typically fluctuate within a narrower range than short-term rates; but in the present instance, other powerful factors have also been at work. Fears of inflation are still widespread, and long-term interest rates therefore still contain a sizable inflation premium. Moreover, corporations have issued an enormous volume of bonds in the first half of this year; State and local governments have borrowed large sums

in the capital markets; and troublesome uncertainties have been created by the financial problems of some borrowers in the municipal bond market. Also, the huge financing demands of the Treasury have been a disturbing element in the money and capital markets.

Despite these problems, conditions in financial markets have greatly improved over the past six to nine months, and a financial basis has been established for an upturn in business activity.

Signs have multiplied in recent weeks that the economy is moving through a turning zone from recession to recovery. As already noted, retail sales have been gaining strength progressively since early this year. The appreciable pickup in new auto sales over the past several months is continuing. Sales of new houses started rising early this year, and as the backlog of unsold units declined, building permits and new housing starts also began to move up.

With excess inventories at retail, wholesale, and manufacturing firms being worked off and the curve of consumer sales still rising, businessmen have become more optimistic about the future. New orders for durable goods -- an important leading indicator of industrial activity -- have of late been rising

again. Moreover, industrial production, after declining for eight consecutive months, registered its first advance in June.

In the labor market, too, there are numerous signs of improvement. The range of nonfarm industries adding to the number on their payrolls has been widening steadily, from a low of 17 per cent in February to about 50 per cent in May and June; total employment has increased by 600,000 over the past three months; the average factory workweek has lengthened; and of late, initial claims for unemployment insurance have dropped sharply.

We may be reasonably confident, therefore, that a recovery in business activity will develop soon, if it is not already underway. How strong the recovery will be, no one can foresee with any assurance. There are ample amounts of idle labor and capital resources to permit rapid growth over the next several quarters. Past cyclical experience suggests, moreover, that a steep decline in business activity such as we have experienced is usually followed by a brisk recovery.

A central objective of Federal Reserve policy at the present time is to contribute to a substantial expansion in output and employment. The vigor of economic recovery, however, will depend less on the rate of expansion in money and credit

than on the confidence of the public -- in particular, the willingness of businesses and consumers to put the enormous volume of existing money balances to work.

The turnover of money, or its velocity, varies widely in the course of a business cycle. During the first year of earlier postwar recoveries, the velocity of M_1 -- that is, the ratio of the dollar value of the gross national product to the narrowly defined money supply -- has usually risen about 5 or 6 per cent, compared with a rate of increase in M_1 of around 3 or 4 per cent. As confidence in the economy improves in the months ahead, the velocity of money -- which declined during the past several quarters -- will probably increase significantly. This factor is frequently neglected by economists and others, but we at the Federal Reserve cannot afford to do so.

In conducting monetary policy, we will also have to remain mindful of the urgency of dealing with the longer-run problem of inflation as well as with the current problem of unemployment. Economic recovery is apparently beginning at a time when the rate of inflation, while lower than a year ago, is still well above a tolerable pace. Our objective as a nation should be to achieve further moderation in the advance of the general

price level over the months ahead, and we shall therefore need to avoid actions that threaten an acceleration of inflation later on -- a development that would create even more intractable economic problems than we have yet encountered. I was glad to see the Senate Committee on Banking, Housing and Urban Affairs recognize this basic truth in its recent report on monetary policy, which states unequivocally that "if inflation is rekindled, any recovery will be short-lived and will end in another recession, one almost certain to be more virulent than the present one."

In testifying before that Committee on May 1 of this year, I indicated that the course of monetary policy cannot be understood adequately by focusing on any single measure of money balances. Some observers believe that the Federal Reserve should devote almost exclusive attention to the behavior of M_1 -- that is, currency plus demand deposits. We in the Federal Reserve do not take so narrow a view of our responsibilities.

The public's demand for currency, for checking deposits, for savings deposits, and for a host of other liquid assets is constantly changing. Financial technology in our country has developed rapidly in the past 20 to 30 years. As a rule, consumers

and business firms no longer hold all, or even most, of their spendable funds in the form of currency or demand deposits. More and more corporate treasurers have learned how to get along with a minimum of deposits in their checking accounts. Consumers, too, have learned to keep an increasing part of their transactions and precautionary balances in the form of savings deposits at commercial banks, or deposits in savings and loan associations, or certificates of deposit, or Treasury bills, or shares in money-market funds, or other income-earning liquid instruments. These trends are likely to continue. Use of so-called NOW accounts and other interest-bearing deposits for transactions purposes is growing, and electronic funds transfer systems may well revolutionize the payments mechanism and the forms in which money is held. In this day and age, no single concept of money conveys adequately the spendable funds held by the public.

Viewed in isolation, the behavior of the narrowly-defined money supply, M_1 , can actually be a misleading guide to the degree of monetary ease or restraint. For example, in periods of declining economic activity, both the transactions demand for cash and the private demand for credit will tend to weaken and thus slow the growth of M_1 . But during such periods market

rates of interest usually decline and thereby stimulate faster rates of growth of consumer-type deposits at commercial banks and other financial institutions.

During periods of economic expansion, the behavior of M_1 may again be misleading. At such times, large demands for credit and money are likely to strengthen the growth of M_1 , but open-market interest rates will tend to rise and thereby curtail the flow of individual savings to banks and thrift institutions. A monetary policy formulated on the basis of M_1 alone would ignore the pressures of disintermediation that develop in periods of economic expansion, and thus threaten serious damage to the mortgage market and to the homebuilding industry.

To avoid errors of this kind, the Federal Reserve takes into account the behavior of numerous monetary and credit aggregates in conducting monetary policy. Among these is M_2 , which includes -- besides currency and demand deposits -- consumer-type time deposits at commercial banks; M_3 , a still broader composite, which includes also the deposits at savings banks, savings and loan associations, and credit unions; M_4 , which starts with M_2 and adds large certificates of deposit issued by commercial banks; M_5 , which is more comprehensive

than any of the preceding aggregates, since it includes the currency holdings of the public plus all deposits at all financial institutions; and also the credit proxy, which indicates the funds that Federal Reserve member banks have available for lending.

Besides following these and still other aggregates, we pay careful attention to the condition of financial markets -- that is, to movements in interest rates, lending terms, the liquidity needs of businesses and financial institutions, and other variables, including the foreign exchange value of the dollar. All of these must be given some weight in the conduct of monetary policy.

On May 1 of this year, I informed the Senate Banking Committee that the Federal Reserve was seeking a moderate rate of expansion in the monetary and credit aggregates, and that the course we are pursuing will promote an increase of M_1 between 5 and 7-1/2 per cent over the twelve months ending in March 1976. It was expected that the related growth rates of other major aggregates would be somewhat higher -- with M_2 increasing in a range of 8-1/2 to 10-1/2 per cent; M_3 , in a 10-12 per cent range, and the credit proxy in a range of 6-1/2 to 9-1/2 per cent.

Economic prospects now are not materially different than the Federal Reserve anticipated two or three months ago, and we therefore as yet see no reason to alter the general course of monetary policy. Accordingly, the Federal Open Market Committee has reaffirmed its intent to seek the growth ranges announced earlier. In view of the erratic movements to which monthly figures on money balances are subject, the projected growth ranges for the several aggregates now cover the 12-month span from the second quarter of 1975 to the second quarter of 1976. In the future, we will generally express our projected growth range of each monetary aggregate from a quarterly base, since a three-month average is less subject to erratic movements than is a single-month base.

We have recently experienced some extreme short-run fluctuations in the growth rate of money balances. Such movements may give rise to confusion regarding the course of monetary policy. It may be helpful, therefore, to comment on the huge bulge in the rate of growth of the monetary aggregates during May and June.

This bulge was a direct result of the tax bill passed earlier this year by the Congress. The tax rebate checks and supplemental social security payments disbursed by the Treasury

were temporarily added to the public's holdings of currency, demand deposits, and savings accounts. Thus, M_1 grew at an average annual rate of over 14-1/2 per cent during the months of May and June, and M_2 increased at a rate of about 16 per cent. But by late June and early July, as individuals disposed of their additional funds, the explosion of the monetary aggregates subsided.

The May-June bulge in the monetary aggregates did not come as a surprise, but it was larger than we had expected -- and very much larger than we desired. It must be clearly understood that the Federal Reserve has no intention of permitting rates of increase as high as those in the second quarter to continue. The special Treasury disbursements have come to an end; and the Federal Reserve has already set in motion forces that should, in the near future, return the growth of the monetary aggregates to the moderate path desired. True, these recent actions have left their mark on short-term market rates of interest. But we have succeeded in avoiding during the past two to three months the severe and damaging effects on credit markets that would have occurred if we had pursued a rigid money supply objective, such as some economists keep urging on us.

As recent experience indicates, short-run variations in the stock of money may not at all reflect the intent or the underlying course of Federal Reserve policy. My colleagues and I have frequently noted that short-run movements of the monetary stock have little significance, and it is good to have the opportunity to state once again that far more attention is given to these short-run fluctuations than is warranted. Actually, our studies indicate that large deviations in the growth of money from a long-run path may occur for half a year or even longer and still have a negligible effect on the workings of the real economy. We must learn to recognize that monthly fluctuations such as those in the rate of growth of the money stock, however defined, are characteristic of almost any series in which monthly changes are small relative to the level of the series.

In view of considerations such as these, the Federal Reserve focuses its attention principally on an appropriate growth of money balances over periods running from six months to a year. Unfortunately, our ability to control this longer-run rate of monetary expansion is less precise than it should or could be. Deficiencies in existing statistical data are part of the problem. Steps have been taken by the Federal Reserve to speed the collection

of data and to improve its quality. We have also been exploring, with the cooperation of the Federal Deposit Insurance Corporation, methods to obtain better estimates of money balances held at nonmember banks. The information now available regarding demand deposits at nonmember banks is entirely inadequate, and at times has misled the Federal Reserve and the public as to the actual course of monetary expansion.

Our control over the nation's money stock would be imprecise, however, even with the best of statistical information. The Federal Reserve's influence over the money stock is indirect. The principal means we use to regulate the growth of money and credit is to buy or sell government securities in the open market. These transactions are taken at our initiative, and in such dollar amounts as we deem appropriate. The size of the Federal Reserve's portfolio of securities is thus under our control. The response of the money stock to an open market purchase or sale, however, is determined by decisions of commercial banks and of the public at large -- decisions over which we have no control.

For example, a purchase of securities by the Federal Reserve would lead to little or no increase in the reserves of

member banks if there were an equivalent rise in the public's holdings of currency, or if member banks used the additional funds to repay indebtedness to their Federal Reserve Banks. Alternatively, member banks might choose to add to their excess reserves instead of employing the newly acquired funds for lending or investing. In that event, there would be no multiplier effect of reserve expansion on deposit creation.

The choices made by the public as to the form in which newly-created deposits are held, and the type of commercial bank in which the funds are deposited, also influence the response of the money stock, particularly M_1 or M_2 , to a reserve injection. The response of the narrowly-defined money supply would be larger if the public increased its holding of demand deposits at smaller member banks, since reserve requirements at these banks are lower than those at the larger member banks. And, of course, the freedom of the public to choose between demand and time deposits can alter materially the amount of aggregate deposits that can be supported by a given volume of reserves.

Part of the imprecision in monetary control also arises from the fact that a sizable fraction of money balances is held at banks that are not subject to the reserve requirements set by the Federal Reserve. Once the Congress sees fit to adopt

the legislation on uniform reserve requirements that we have been seeking for several years, the Federal Reserve's control over the monetary aggregates will be improved, and financial institutions offering similar deposit services will at the same time be treated more equitably.

In closing, let me remind this distinguished Committee that the growth ranges for the monetary aggregates that we have projected for the next year may need to be adjusted one way or another. Clearly, the growth rates presently sought by the Federal Reserve, while appropriate in the present environment of high unemployment and unused industrial capacity, could not be maintained indefinitely without rekindling inflationary forces. As the economy returns to higher rates of resource utilization, it will be necessary to reduce the rate of monetary and credit expansion, so that the basis for a lasting prosperity is laid.

We must not lose sight of the fact that the principal cause of the current recession is an inflation that got out of control. Our nation has paid a heavy price during the past year for neglect of this serious problem. All of us in government must work to promote a good recovery in economic activity; but all of us must also take great care lest the hard-won gains

of the past year are nullified by a new round of inflation. The rise of the consumer price level in June at an annual rate of over 9 per cent is a warning that the menace of inflation is still very much with us. The task now facing our country, therefore, is not only to hasten the process of economic recovery, but also to unwind the inflation and thus lay the basis for a lasting prosperity.

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