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Statement by

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Committee on the Budget

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I am pleased to meet with this Committee today to discuss the condition of the national economy and the course of monetary and fiscal policy.

The American economy is now in process of emerging from the deepest decline of business activity in the postwar period. Total industrial production has risen in each month since April, and the scope of the recovery is broadening. At the same time, the demand for labor has been improving. This August, 1-1/2 million more workers were employed than in March. The unemployment rate has declined from a peak of about 9 per cent in May to about 8 per cent currently. And the lengthening of the average workweek in our factories is indicative of a return to more normal production schedules.

As we look back, it is clear that the consumer has led the way out of recession and into recovery. Early this year, when price concessions became common, consumer purchases began to pick up. Retail sales of nondurable goods have risen briskly, and by this summer exceeded their level in the final quarter of 1974 by 8 per cent in dollar terms, and 3 per cent in real terms. As confidence improved, consumers also became more willing to dip into their savings or to incur new indebtedness in order to purchase big ticket items. Thus, outlays for consumer durables have also strengthened. This is clearly evident in the automobile sector where sales of new cars have been running recently at around a 10 million annual rate -- a considerable advance from the 7 million rate recorded last November.

The spending of consumers has not been the only element of strength in the economy this year. A sharp turnaround in foreign trade has also helped to pave the way for recovery. Our merchandise trade balance was unfavorable throughout 1974 and reached an unprecedented $9 billion annual rate of deficit in the third quarter. But a deep cutback of imports, especially of fuel and of industrial supplies, occurred during the recession, while the demand for our exports held up well. The result was a swing in our trade position to a surplus at an annual rate of over $13 billion in the second quarter of this year. The rise in the value of the dollar in foreign exchange markets reflects this basic improvement of our international competitive position.

The sustained buying by foreigners and American consumers at a time of declining industrial production has enabled business firms to make remarkable progress in clearing their shelves of excess inventories. Liquidation of inventories got underway around the turn of the year, and by the second quarter the rate of decline was larger in relation to the gross national product than in any quarter of the entire postwar period. The ratio of stocks to sales began to decline at retail stores in January; reductions soon followed in factories producing non-durable goods and more recently in durable goods manufacturing. The improvement in industrial production over recent months reflects the better balance between inventories and sales that developed as this inventory adjustment took place.

The basis for recovery was laid in large measure by adjustments of the private economy that served to correct the imbalances which had precipitated the recession. Most notably, the slowing of inflation helped to rebuild confidence and led to larger consumer spending early this year. By the second quarter, the annual rate of increase in the general price level had receded to 5-1/2 per cent -- half that of a year earlier. In the highly competitive environment created by the recession, business managers found it necessary to devote more attention to cost controls and improvements in efficiency. Their efforts have begun to bear fruit, as is evidenced by the increase in output per manhour during the second quarter -- the first increase in over two years.

The self-corrective forces of the recession have been aided materially by fiscal and monetary policies that sought to cushion the effects of economic adversity and to provide some stimulus to economic recovery. On the fiscal side, public employment programs were expanded, unemployment insurance was liberalized, and income taxes were reduced. The Tax Reduction Act of 1975, besides bolstering consumer purchasing power, strengthened incentives for business investment in fixed capital.

On the monetary side, Federal Reserve policies sought to bring about substantial improvement in financial conditions. Interest rates -- particularly on short-term loans and securities -- moved to lower levels as a result of declining credit demands and the efforts of the Federal Reserve to increase the availability of money and credit. Business corporations made effective use of the easier credit conditions that have prevailed this year. They have issued exceptionally large amounts of long-term securities, and they have used much of the proceeds to repay short-term debt or to acquire liquid assets. Banks and other financial institutions also have strengthened their liquidity position. Consumers too have paid down some of their indebtedness, while adding substantially to their savings deposits and other financial assets.

The easing of credit conditions has been helpful to the severely depressed housing sector. Lower rates of interest on market instruments encouraged a larger flow of savings funds to specialized mortgage lenders; the turn occurred last fall, and a substantial rise in new mortgage loan commitments soon followed. Early this year, the volume of sales of both new and old dwellings turned up, and these sales are continuing to run well above their lows of last winter. With better market conditions, housing starts -- especially of single-family dwellings -- have been moving up again.

The recovery process thus appears to be broadening and gathering momentum. Monthly statistical reports on employment cover each of 172 nonfarm industries. In February, only 17 per cent of these industries reported an increase of employment over the preceding month. Since then, the percentage of improving industries has gone up steadily, and reached 72 per cent in August. Industrial production rose 1.3 per cent in August, far more than the gain in any of the three previous months. The acceleration of industrial activity reflects stronger consumer demand for goods and services. It also reflects the fact that inventory liquidation has slowed, or has given way in some branches of industry to renewed accumulation. This is the beginning of a process of rebuilding stocks that should provide considerable thrust to economic activity over the next year.

In addition, many signs now seem to be pointing to an early turnaround in business fixed investment. The latest government survey of spending on plant and equipment suggests that business plans for capital outlays have stabilized. New orders for nondefense capital goods already have risen appreciably from their March trough. Production of business equipment increased in August after ten consecutive months of decline. The decline in contracts for commercial and industrial construction appears to have ended. The rate of formation of new firms -- a useful early indicator of capital investment -- is moving upward again. Once expenditures on plant and equipment begin to contribute to cyclical recovery -- as I believe they soon may -- the pace of overall economic expansion is likely to become quite vigorous.

The strength of economic recovery, however, could be undermined by a renewal of strong inflationary pressures. We have already witnessed an ominous upsurge in prices during the third quarter. Wholesale prices rose at an average annual rate of 12 per cent in July and August. Consumer prices have also advanced more rapidly, though there was some improvement in August. To be sure, special factors --

Russian grain purchases and the further rise in energy prices -- contributed to the spurt in the price indexes, but that is only a part of the story. Price increases have also occurred in various industries -- autos, steel, aluminum, industrial chemicals, among others -- where considerable slack exists. And the recently announced increase in the price of imported oil is bound to lead to price advances over a wide range of domestic petroleum products.

These developments must be viewed with concern. It was uncontrolled inflation that brought on the severe economic decline we have recently experienced, and we must recognize the threat to a sustained recovery embodied in any new wave of inflation. Wider expectations and fears of inflation already are beginning to manifest themselves. Financial markets -- specifically the behavior of interest rates and stock prices -- have become very sensitive to any indication or suggestion of accelerating inflation. History suggests that at this early stage of a business upturn, confidence in the economic future should be strengthening steadily. A revival of consumer and business confidence is indeed underway, but it is being hampered by concern that a fresh burst of double-digit inflation may develop and, before long, bring on another recession.

In setting monetary policy, the Federal Reserve has been alert to developments in the sphere of prices. We have been equally alert to the need to provide the financial basis for economic recovery. In effect, we have sought a prudent middle ground. This is reflected in the monetary growth paths specified by the Federal Open Market Committee for the twelve months ending in the second quarter of 1976 -- that is, growth of 5 to 7-1/2 per cent in M_1 (which includes currency plus demand deposits), 8-1/2 to 10-1/2 per cent in M_2 (which includes, besides M_1, consumer-type time and savings deposits at commercial banks), and 10 to 12 per cent in M_3 (which includes, besides M_2, deposits at thrift institutions).

These growth ranges are appropriate under current conditions, when the economy is just beginning to emerge from recession and is still struggling with widespread unemployment of labor and industrial capital. However, by historical standards, these growth ranges are on the generous side, and our economy would have little or no chance of regaining general price stability if they were maintained indefinitely. Even so, the Federal Reserve System has been frequently urged to raise its present target rates for the money supply. We have resisted these suggestions because, in our judgment, such a policy would soon lead to accelerated inflation and thereby frustrate the process of economic recovery.

A similar judgment was reached last spring by the Senate Committee on Banking, Housing, and Urban Affairs in its report on the monetary policy oversight hearings. The Committee expressed the belief "that pursuit of the monetary policy plans announced by the Federal Reserve Board will be helpful to the nation's economic recovery," and stated unequivocally its agreement that "if inflation is rekindled, any recovery will be shortlived and will end in another recession, one almost certain to be more virulent than the present one."

Late this spring, growth of the various money supply measures spurted far above the longer-run target ranges as tax rebates and special social security payments disbursed by the Treasury were temporarily added to the public's holdings of currency, demand deposits, and savings accounts. Some transitory increase in monetary expansion was viewed as necessary by the Federal Reserve System, in view of the nature of the fiscal actions that had been voted by the Congress. The bulge in the monetary aggregates was expected to be largely self-correcting as recipients of the Treasury payments spent the proceeds or shifted them to more permanent savings forms.

In fact, the increase in the money supply was considerably larger than we had anticipated, and threatened to raise the longer-term monetary growth rates to unacceptably high levels. The Federal Reserve therefore set forces in motion to ensure a return to the more moderate expansion path desired. These actions, along with exceptionally heavy Treasury borrowing and the early signs of economic recovery, served to raise short-term market rates of interest somewhat. This appeared to us to be unavoidable if monetary expansion over the longer run was to be held within appropriate bounds. Our policy moves -- and the subsequent moderation in monetary growth rates during the summer months -- certainly helped to reassure the business and financial community that the Federal Reserve would continue to steer a course toward sustainable economic growth.

The Federal Reserve, however, cannot alone be expected to assure success in the battle against inflation. The general public, as well as the business and financial community, is watching to see whether Congress and the Administration will pursue a course of fiscal prudence. The credit markets currently face an enormous demand for funds from the Treasury. Recently, official estimates of Treasury borrowing in the second half of this year were raised by $3 to $6 billion because, among other reasons, expenditures are outrunning earlier projections. The announcement of this larger need drove interest rates on Treasury securities to a higher level and served to raise private borrowing costs as well. The massive Federal deficit may well cause a further rise in interest rates, and this can have an adverse effect on business capital investment and on residential construction.

Therefore, it is of the utmost importance that this Committee persuade the Congress to hold expenditures for fiscal 1976 at or below the levels specified in the First Concurrent Resolution. Not only that, but this Committee and the Congress should be seeking ways to pull back on the growth of Federal spending as the recovery gathers momentum. Such a fiscal course will enhance the prospects for regaining price stability and a lasting prosperity.

I find it disturbing that some economists are today proposing additional stimulative measures on the basis of their projections that a larger gain in employment might be achieved over the next year with minimal effects on the rate of inflation. Such recommendations miss the mark for two reasons. First, they fail to take account of the sensitivity to rising rates of inflation that people in our country and elsewhere have exhibited in recent years. In practically every industrial nation, more rapid inflation has led to larger precautionary savings and sluggish consumer buying. Second, they fail to look far enough into the future, for it may not be until two or three years down the road that the full inflationary impact of more stimulative policies would be felt. To overlook these basic facts of economic life is to court disaster.

Once inflation has come to dominate the thinking of consumers and businesses -- and this I believe to be our present condition -- there is no longer a meaningful trade-off between unemployment and inflation. Even if highly expansionary monetary and fiscal policies could, for a short time, provide some additional thrust to economic activity, the resulting acceleration of inflation would soon create even more difficult economic problems than we have yet encountered. The American people have paid a heavy penalty for past neglect of economic realities. The only sound fiscal and monetary policy today is a policy of prudence and moderation.