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Statement by

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before the

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I am pleased to meet with this Committee to report once again on the condition of the national economy and the course of monetary policy.

When I submitted to you the Federal Reserve's report on May 1, the American economy was at the trough of the deepest decline in production of the entire postwar period. Since then, a recovery of economic activity has gotten underway. Between April and September, industrial production rose almost 6 per cent; each month's increase exceeded that of the month before, and the September increase was the largest in over a decade. The scope of the recovery has also been broadening. Production of durable goods has advanced strongly of late and the increase of activity in the non-durable goods sector -- which began earlier -- has continued. Improvement has spread beyond the nation's factories, mines, and power plants, and the over-all increase in the physical volume of production during the third quarter turned out to be one of the largest in recent years.

As real output moved upward, the demand for labor kept strengthening. Since March, total employment has risen by more than 1-1/2 million. The average factory workweek has lengthened appreciably. Unemployment has declined from its peak in May despite a sizable increase of the labor force this year. And the increase of employment has become more widely diffused across the economy. Of the 172 non-farm industries on which the Bureau of Labor Statistics reports, only 17 per cent experienced an increase of employment in February. The corresponding percentage rose with considerable regularity in succeeding months and reached 72 per cent in September.

As we look back, it is clear that the consumer led the way out of recession and into recovery. Early this year, when price concessions became fairly common, consumer purchases began to pick up. Consumer buying was further buttressed over the spring and summer months by tax rebate checks and supplementary social security checks. Retail sales of nondurable goods rose briskly; and as confidence improved, consumers also became more willing to dip into savings or incur new indebtedness in order to purchase big-ticket items. This is clearly evident in the automobile sector, where sales of new cars have been running recently at an annual rate of around 9-1/2 million -- a considerable advance from the 7 million rate of last November.

A sharp turnaround in foreign trade also helped to pave the way for economic recovery. Our trade balance was unfavorable throughout 1974, and the deficit reached an unprecedented $9 billion annual rate in the third quarter of last year. But a deep cutback of imports -- especially of fuel and 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. There has been a significant rise of imports recently, as is to be expected during a cyclical expansion. Nevertheless, our trade surplus is still large, the over-all balance of payments remains favorable, and the dollar is again a highly respected currency around the world.

Sustained buying by foreigners and American consumers enabled business firms to make excellent progress in clearing their shelves of excess inventories. Liquidation of inventories got underway around the beginning of this year, and in 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. By early summer, stocks were coming into reasonable balance with sales in most consumer lines, and many firms engaged in retail and wholesale trade therefore began to rebuild inventories.

Meanwhile, the pace of inventory liquidation slowed considerably in the manufacturing sector. For business firms in the aggregate, inventory liquidation receded from an annual rate of about $30 billion in the second quarter to a rate of $10 billion in the third. This shift in business inventory investment has been a major factor in the recent sharp rise of our nation's production of goods and services.

The willingness of businessmen to move further in replenishing depleted stockpiles, and thereby provide a continuing thrust to general business activity, will depend heavily on the strength of consumer demand. That in turn will be influenced materially by the real income of consumers, their financial position, and the state of confidence -- all of which are linked to inflationary developments and prospects. In the Board's judgment, improvement of the economy is likely to continue at a satisfactory pace only if consumers and businessmen can reasonably look forward to some further abatement of cost and price inflation.

We as a nation have made notable progress in reducing the rate of inflation that prevailed during 1974. Consumer prices rose over the first three quarters of this year at about half the pace recorded a year earlier. The rise in wholesale prices slowed even more. These improvements resulted mainly from slack demand in product markets and the competitive pressures that forced business managers to watch costs more closely and to enhance efficiency. These efforts have begun to bear fruit; output per manhour turned up in the second quarter -- thus registering the first increase in over two years -- and rose further in the third.

Of late, however, there has been some worsening in the rate of inflation. Broad measures of price performance indicate a rise in the third quarter at an annual rate of around 7-1/2 or 8 per cent -- compared with 5-1/2 per cent in the second quarter. To be sure, special factors -- such as the unexpected Russian need for grain and the further rise of energy prices -- were partly responsible for this development. But price increases have also occurred in a number of industries -- autos, steel, aluminum, and chemicals, among others -- where considerable slack still exists. And the increase in the price of imported oil that went into effect on October 1 may well lead to price advances over a wide range of products in the months ahead.

Some step-up in the rate of increase in the general price level was perhaps unavoidable, in view of the vigor of economic recovery and the persistent rise of wages. Nevertheless, the quickening in the pace of inflation during recent months -- in the face of high unemployment and widespread excess industrial capacity -- is a clear warning that our long-range problem of inflation is unsolved and remains a threat to continuance of economic recovery.

Elimination of the long-run inflationary bias of our economy will require progress on numerous fronts, including a marked strengthening of business expenditures for new plant and equipment. Growth and modernization of the nation's industrial capacity are essential to avoid a recurrence of capacity shortages in critical sectors of the economy, to lay the basis for greater improvements in productivity, and to expand job opportunities for our people.

As often happens in the early months of a cyclical upswing, business spending for fixed capital has lagged behind the recovery in other sectors. The rise that appears to have occurred recently in the production of business equipment is as yet inconclusive. Various indicators suggest, however, that an upturn of business capital investment may not be far away. Contracts for commercial and industrial construction have stabilized during recent months. New orders for nondefense capital goods, though edging off in the past two months, are now about 8 per cent above their level in March. Moreover, the rate of formation of new business firms -- another advance indicator of business capital investment -- is moving up again.

Further improvement in the homebuilding industry is also a vital ingredient of a full-fledged economic recovery. The decline in market rates of interest that began in the summer of 1974 bolstered the flow of savings to mortgage-lending institutions last fall, and a substantial rise in mortgage loan commitments soon followed. Early this year, the volume of sales of both new and old dwellings rose, 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 in home building, however, has been weak. Prices of new and existing houses, to say nothing of other costs of homeownership, have risen so drastically that many American families cannot afford to buy a home. Builders, moreover, remain very cautious in view of the overbuilding and financial difficulties of recent years.

Mortgage lenders have also remained cautious, in part because of fears that the enormous financing requirements of the

Federal Government would drive up market interest rates and thereby attenuate the flow of funds to thrift institutions. The Federal budgetary deficit during the third quarter was the largest on record. In just three months, the volume of Treasury bills outstanding rose by $14 billion. Since commercial banks reduced their purchase of government securities as loan demands strengthened, a substantial volume of Treasury bills had to be absorbed by the general public. Borrowings by the Treasury in the two-to-three-year maturity range were also very heavy. A series of such note issues in August and September drove up interest rates, attracted a sizable number of individual investors, and served to reduce the flow of savings to banks and thrift institutions.

These developments left their mark on the residential mortgage market. Lenders became more hesitant to commit funds, and interest rates on new mortgage loan commitments drifted upward. Nevertheless, mortgage rates remain below their 1974 peaks, and funds remain readily available in nearly all areas of the country where unrealistic interest rate ceilings do not impede the flow of credit.

Increases of interest rates have been particularly prominent in the market for State and local government securities.

The financial problems of New York City have had widespread repercussions on the cost and availability of credit to State and local governments. Although yields on high-grade municipal obligations have risen about in line with yields in other long-term markets, increased investor caution has resulted in a marked widening of yield differentials between municipal issues of high quality and those of lower quality. Authorities with relatively low credit ratings have experienced pronounced increases in borrowing costs and, in some instances, they have been effectively excluded from the public market. Despite these adversities the municipal bond market continued to function well enough to permit a record volume of long-term issues during the third quarter. In the past few weeks, however, the volume of new municipal issues has dropped appreciably.

Of late, the need of business firms to borrow in the long-term capital market has diminished as their liquidity generally improved, and as the downward adjustment of business inventories and better profits generated an enlarged flow of cash. During much of this year, however, the market for long-term funds has been under pressure -- first, from corporate security issues, later from heavy Treasury borrowing and an extraordinary volume of new municipal securities. The Federal Reserve has sought to provide some assistance to the long-term market by shifting the emphasis in its open-market operations from Treasury bills to longer-term securities. Since the beginning of the year, the System has acquired over $6 billion of Treasury and Agency issues bearing maturities of over 1 year. Of this total, $2 billion was acquired since mid-year.

These purchases have been helpful in steadying the bond market during periods of unusual tension, but they can have only an ephemeral influence on long-term interest rates. The fundamental factor forcing up long-term interest rates in recent years has been the high rate of inflation which persistent deficits in the Federal budget kept fueling. Appreciably lower long-term interest rates would, I believe, contribute powerfully to economic expansion, but they are unlikely to be attained unless significant progress is made in closing the budgetary deficit and in bringing inflation under control.

Exercise of fiscal discipline at all governmental levels is badly needed to ease the tensions and uncertainties that have disturbed financial markets this year. The pressure of Federal financing on interest rates during the third quarter resulted not only from the sheer massiveness of the Federal deficit, but also from successive upward revisions in borrowing needs. The sharply higher yields in the market for municipal securities have reflected the heavy borrowings by State and local governments as well as reduced confidence in the finances of some of these governmental units. The climate for economic expansion would be greatly improved by clear evidence that governmental authorities at all levels are finally willing to live within their means and to get along without financial gimmickry.

We in the Federal Reserve fully recognize that monetary policy has an important role to play in maintaining a financial environment that is favorable to sustained economic expansion. The strength of the economic recovery to date has been heartening, but we are still a long way from reasonably full employment of our labor and capital resources. The reduction in the rate of inflation accomplished this year has also been encouraging, but we are still a long way from reestablishing reasonable stability in the price level. In light of these facts, the only responsible option open to the Federal Reserve is to pursue a course of moderation in monetary policy -- a course that will provide expansion in supplies of money and credit adequate to facilitate further good recovery of production and employment, but not so large as to rekindle the fires of inflation.

To implement this course of policy, the Federal Open Market Committee has projected growth ranges of the monetary aggregates that differ little from those announced previously. For M_1, which includes currency and demand deposits, the projected growth range for the coming year is again 5 to 7-1/2 per cent. For M_2, which includes consumer-type time and savings deposits at commercial banks besides the components of M_1, the growth range has been widened by reducing the lower end of the range one percentage point. The growth range for M_3, which includes deposits at thrift institutions besides the components of M_2, has been similarly widened. These adjustments were made in view of recent experience, which suggests that pressures on market interest rates stemming from heavy Treasury borrowing tend to moderate inflows of savings funds to depositary institutions. The growth range projected is thus 7-1/2 to 10-1/2 per cent for M_2, and 9 to 12 per cent for M_3.

These growth ranges now apply to the period extending from the third quarter of 1975 to the third quarter of 1976 -- rather than from the second quarter of 1975 to the second quarter of 1976. This updating of the base, I should note, implies a slightly higher level of money balances a year from now than would be the case if the second-quarter base were retained.

Since I last reported to this Committee on May 1, growth of the monetary aggregates has been broadly in line with the ranges we adopted earlier. However, month-to-month and quarter-to-quarter changes in the aggregates have been very large, reflecting unusual factors influencing the public's demand for money.

The largest short-term variation occurred in M_1, the narrowly-defined money stock. Thus, M_1 grew at an exceptionally high annual rate -- 11.2 per cent -- during the second quarter, as the public's holdings of cash bulged during May and June because of the tax rebates and special social security payments authorized by the Congress. As these excess balances were subsequently drawn down, growth of M_1 slowed to a 2.2 per cent annual rate from July through September. There were similar, though smaller, variations in the growth rates of M_2 and M_3.

Measured on the basis of quarterly averages, the pattern of monetary expansion was much more stable. M_1 increased at an annual rate of 8.6 per cent between the first and second quarters, and 6.9 per cent between the second and third quarters. The comparable figures were 11.2 and 10.4 per cent for M_2, and 13.8 and 13.1 per cent for M_3.

Short-run fluctuations in the rate of monetary growth are practically unavoidable, but they also have little significance for the functioning of the real economy. That is why we use quarterly average levels of money balances as the base for specifying longer-run objectives for monetary expansion. However, we cannot ignore the short-term movements of money balances in the conduct of monetary policy, since it is necessary to be alert to any large and protracted departure of monetary growth rates from longer-run objectives.

Around the middle of this year, the major monetary aggregates were increasing at rates far above the longer-run ranges the Federal Reserve was seeking. We therefore set forces in motion which helped to return the pace of monetary expansion to the moderate rate desired. More recently, increases in the monetary aggregates have fallen below our projected ranges. Once again, steps have been taken -- including a modest reduction in reserve requirements -- to encourage a return to the desired path of long-run monetary expansion.

These corrective actions have had some influence on the level of interest rates -- particularly short-term rates -- which rose conspicuously in late June and early July, but have recently retreated on a broad front. Temporary fluctuations such as these in short-term market interest rates are an inevitable by-product of efforts to keep the rate of monetary expansion from straying too far from the desired longer-run path. It is important to recognize that the Federal Reserve's conduct of monetary policy conforms in this respect not only to our best judgment, but also to the spirit of House Concurrent Resolution 133.

The longer-range growth rates of the monetary aggregates we are now seeking are, we believe, adequate to finance a vigorous further expansion in real economic activity. Let me stress once again, however, that the relation over time between money balances and the physical volume of economic activity is rather loose, since so much depends on the willingness of businessmen and consumers to use their existing money holdings. We know from earlier history that the turnover of the narrowly-defined money stock tends to rise faster in the recovery stage of the business cycle than does the monetary stock itself. Recent experience has confirmed this tendency. Thus, between the second and third quarters of this year, M_1 rose -- as I earlier noted -- at a 6.9 per cent annual rate. But the income velocity of M_1 -- that is, the ratio of GNP to M_1 -- rose during that period at an annual rate of 8.7 per cent.

In deciding on the appropriate target ranges for growth of the monetary aggregates, we at the Federal Reserve must carefully consider the probable movements of income velocity over the course of the business cycle. We must also bear in mind that innovations in financial markets can have large effects on the economy's needs for money and other assets to finance economic expansion and to satisfy the public's liquidity preferences.

We are living in a time of rapid changes in the public's demand for currency, for checking accounts, for savings deposits, and for a host of other liquid assets. Over the past 20 or 30 years, dramatic developments in financial technology have reduced substantially the proportion of spendable funds that is held in the form of currency and 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 a larger 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 of money-market funds, or other income-earning liquid instruments. Of late, telephonic transfer of funds from savings accounts to checking accounts is accelerating the trend toward holding transactions balances in income-earning form.

Furthermore, as a result of recent financial innovations, liquid assets other than currency or checking deposits are being used to an increasing extent directly for transactions purposes. Since 1970, customers of mutual savings banks and savings and loan associations have been able to authorize payment of regularly-scheduled household expenditures, such as mortgage payments, directly from their savings accounts. This year, authority for such third-party transfers was broadened to include any payment, regardless of purpose, and permission was granted to commercial banks to offer similar services to their customers. And since 1974, commercial banks and thrift institutions in Massachusetts and New Hampshire have been allowed to offer so-called "NOW" accounts to their customers. These accounts pay a rate of interest that practically equals the rate on regular savings accounts, and yet they permit direct transfer of funds through a negotiable instrument comparable to a check.

These changes are having a significant impact on the type of financial assets that the public holds to meet its transactions needs, and on the range of financial institutions that are involved in supplying payments services. Savings and loan associations and mutual savings banks, as well as nonmember commercial banks, are now an important part of the Nation's payments mechanism. And yet they are not subject to the reserve requirements imposed by the Federal Reserve on member banks. As a consequence, the scope of monetary control exerted by the Federal Reserve is being eroded.

The financial innovations that I have described so summarily are also increasing the difficulties of determining the growth rates of the monetary aggregates that are appropriate at any given time. Clearly, the Federal Reserve cannot focus attention exclusively on any single measure of money balances. We must be alert to the possibility that our longer-run projected ranges for the monetary aggregates may need to be altered in view of changes in financial technology as well as more basic economic and financial developments.

Let me remind this Committee, finally, that the growth rates of money and credit presently desired by the Federal Reserve cannot be maintained indefinitely without running a serious risk of releasing new inflationary pressures. As the economy returns to higher rates of resource utilization, it will eventually be necessary to reduce the rate of monetary and credit expansion. The Federal Reserve does not believe the time for such a step has yet arrived. But in view of the economic recovery that has been underway since last spring, we are closer to that day now than we were six months ago.

Our Nation is confronted today with a serious difficulty in its search for ways to restore full employment. Highly expansionist monetary and fiscal policies might, for a short time, provide some additional thrust to economic activity. But, later on, the rate of inflation would accelerate sharply -- a development that would create even more difficult economic problems than we have yet encountered. This Committee's report on monetary policy, issued in June, recognized this basic truth in stating 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."

Conventional thinking about stabilization policies, as I tried to explain in a recent address at the University of Georgia, is inadequate and out of date. Stimulative financial policies have considerable merit when unemployment is extensive and the price level is stable or declining. But such policies do not work well when the price level keeps on rising while there is considerable slack in the economy. Experience both in our own and other industrial countries suggests that once inflation has come to dominate the thinking of a nation's businessmen and consumers, highly expansionist monetary and fiscal policies do not have their intended effect. That is, instead of fostering larger consumer spending and business investment, they may well lead to larger precautionary savings and sluggish consumer buying.

The only sound fiscal and monetary policy today is a policy of prudence and moderation. New ways must be found to bring unemployment down without becoming engulfed in a new wave of inflation. That is why structural policies require far more attention than they are being accorded by academic economists or members of the Congress.

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