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Statement by

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before the

Committee on the Budget

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I am glad to represent the Federal Reserve Board at these Hearings on the budget for fiscal year 1977. For many years, I have strongly urged a reform of Federal budgetary procedures. The Congressional Budget and Impoundment Control Act of 1974, which this Committee is implementing, was a gigantic stride in that direction. Your efforts to bring order to our budgetary affairs can play a vital role in the restoration of confidence in our Nation's future.

My comments today will be directed, first, to the condition of the national economy, and second, to the implications of prospective economic and financial developments for public policy.

A year ago, when this Committee began to consider the fiscal 1976 budget, our economy was in the final stages of the most severe recession of the postwar period. But an upturn in business activity soon got under way, and we have experienced since last spring a substantial economic recovery. During the second half of 1975, the physical volume of our Nation's total production rose at an annual rate of 8 per cent.

The rebound of the industrial sector of our economy has been even stronger. The advance was initially most prominent

in the textile, leather, paper, and chemical industries. The scope of recovery broadened during the fall and winter months and now includes a wide range of durable and nondurable goods. Since last April, the combined output of factories, mines, and power plants has increased at an annual rate of 11-1/2 per cent.

As production rose, the demand for labor strengthened. Employment across the nation has risen by more than 2 million since last spring, and the average factory workweek has lengthened by 1-1/2 hours. Meanwhile, the unemployment rate has come down from about 9 per cent to 7-3/4 per cent. This January, the number of workers added to payrolls by our manufacturing industries exceeded the number released by a margin of nearly 4 to 1. The rate of utilization of our industrial plant has also risen substantially.

These developments have improved the state of confidence, and significant further increases in production and employment can be counted on this year. Last fall, the pace of advance in economic activity slowed for a very brief period; but a renewed upswing developed toward year end, and the economy entered 1976 on a strong upward trend. Consumers have been buying more liberally. In December, retail sales rose almost 3 per cent on a seasonally adjusted basis, and this advance has been

extended since then. The rate of sales of new automobiles during the first 20 days of February was the highest since August 1974, and there are even some signs of revived interest in more expensive cars.

This marked strengthening of consumer spending has resulted in further liquidation of business inventories, so that the ratio of inventories to sales is now low at most retail outlets, and also at manufacturing establishments producing non-durable goods. Vendors in many lines are less able to meet demands from existing stocks, and delivery times are lengthening. Businessmen therefore are increasing orders and production in an effort to rebuild inventories to levels consistent with the improved pace of consumer buying. Accumulation of needed inventories should act as a significant stimulus to recovery throughout most of this year.

Prospects for residential construction also have improved. Prices of new homes remain exceedingly high, and this is limiting the recovery in homebuilding. Nevertheless, the inventory of unsold units has declined, rental vacancy rates have fallen sharply, and mortgage credit is now readily available in practically all parts of the country. Although housing starts have edged down somewhat of late, building permits have continued to advance,

and the gains in homebuilding made during 1975 are likely to be extended significantly this year.

Exports, too, will probably register further improvement this year. Economic recovery is finally under way in Japan and in other industrial countries, and as it gathers momentum the demand for our exports should intensify. However, the foreign trade balance is likely to narrow this year, because our own economic expansion will lead to an enlarged demand for imports -- including products, such as petroleum and industrial supplies, that fell off sharply during the recession.

Business capital spending can also be expected to contribute to economic expansion in the year ahead. Although production of business equipment has risen in the past several months, and new orders for capital goods advanced materially in January, this sector of demand has yet to evidence a solid upturn. However, with rates of capacity utilization increasing, corporate profits moving up strongly, the stock and bond markets improving, and business confidence gaining, we can reasonably expect considerable strengthening this year in business plans for buying new equipment and building new facilities -- as normally happens in the course of a business-cycle expansion.

The precise magnitude of the recovery in business investment outlays will depend to a large degree on the vigor of consumer markets. While the recent improvement in consumer buying has been encouraging to the business community, the present more optimistic mood of consumers could be destroyed by a new burst of inflation. Any resurgence in the pace of inflation this year would pose a threat to consumer and business confidence, and thus to the further recovery of economic activity that is so urgently needed.

Our Nation made notable progress last year in reducing the rate of inflation. The rise in consumer prices came down to 7 per cent, well below the rate recorded in 1974. The rise in wholesale prices slowed even more. Much of this improvement, however, stemmed from the absence of powerful special factors -- such as the quadrupling in prices of imported oil, short supplies of agricultural commodities, and the termination of wage and price controls -- which drove up prices in 1974.

The progress made on the price front in 1975, while heartening, still left us a long way from our national goal of general price stability. Moreover, though declines in farm and food prices have moderated the rise in wholesale and

consumer prices over the past few months, there has been no basic improvement in the trend of inflation since the summer of 1975. On the contrary, since last June, wholesale prices of industrial commodities have increased on the average at an annual rate of 8 per cent, compared with 3-1/2 per cent in the first half of last year. The advance of consumer prices has quickened only a little -- from an annual rate of 6-1/2 per cent in the first half of 1975 to 7-1/4 per cent since last June. Even so, the failure of the inflation rate in consumer markets to continue declining is a troublesome sign.

Some step-up in the rate of inflation was perhaps unavoidable in view of the economic recovery and the relentless advance of wages. Therefore, as the recovery proceeds, it will be all the more important that our government manage economic policies so that a new burst of inflation is avoided.

Our country is now confronted with a serious dilemma. Over 7 million people are still unemployed, and many of them have been seeking work for an extended period. More jobs are clearly needed -- not only for workers who are now unemployed, but also for those who will soon be entering the labor force.

In the current inflationary environment, however, expansionist policies of the traditional type cannot be counted on to

restore full employment. Recent experience in both our own and other industrial countries suggests that once inflation has become ingrained in the thinking of a nation's businessmen and consumers, highly expansionist monetary and fiscal policies do not have their intended effect. In particular, instead of fostering larger consumer spending, they may intensify inflationary expectations and lead to larger precautionary savings and sluggish consumer buying. The only sound course for fiscal and monetary policy today is one of prudence and moderation.

One of the urgent tasks facing our Nation is to end the Federal deficits that have been a major and persistent source of our inflation. Since 1960, the Federal budget has been in deficit every year but one. The cumulative deficit in the unified budget over the past ten years, including the official estimate for the current fiscal year, comes to \$217 billion. If the spending of off-budget agencies and government-sponsored enterprises is taken into account, the aggregate deficit for the ten years amounts to almost \$300 billion.

This sorry record of deficit financing means, of course, that we as a people have been unwilling to tax ourselves sufficiently to finance the recent sharp increases of governmental spending.

In this bicentennial anniversary of our Nation's independence, we would do well to reflect on the fact that it took all of 186 years for the annual total of Federal expenditures to reach the \$100 billion mark. This occurred in fiscal year 1962. Only nine years later, in fiscal 1971, expenditures already exceeded \$200 billion. Four years from that date, in fiscal 1975, the \$300 billion mark was passed. And unless expenditures are held under a very tight rein, Federal spending will easily exceed the \$400 billion level in fiscal 1977.

One aspect of the sharply rising curve of expenditures is that government has been assuming an ever larger role in the economic life of our people. In 1929, Federal expenditures accounted for less than 3 per cent of the dollar value of our total national output, and expenditures at all levels of government -- Federal, state, and local -- amounted to about 10 per cent of the national product. Last year, Federal expenditures alone accounted for about 25 per cent of our national output, and the combined expenditures of all governmental units for almost 40 per cent.

Much of this increase in the role of government in our economy was made necessary by the rapid growth of population

in recent decades, the increasing complexity of modern urban life, the explosion of military technology, and the enlarged responsibilities of the United States in world affairs. However, the trend of Federal spending has also been significantly influenced by strong intellectual currents, both in our country and elsewhere, that keep nourishing the belief that practically all economic and social problems can be solved through the expenditure of public funds.

Where the line can best be drawn between governmental and private use of resources is, in the final analysis, a matter of social or philosophic values and of political judgment. But regardless of how this question is resolved, it should be clear to everyone that Federal spending, whatever its level, must be soundly financed. The large budgetary deficits that have persisted since the mid-sixties -- and in good years as well as bad years -- added little to our capacity to produce, but they added substantially to aggregate monetary demand for goods and services. They were thus largely responsible for the ten-year stretch of accelerating inflation that culminated in the deep recession from which we are now emerging.

The President's budgetary program for the coming fiscal year, taken on an overall basis, would go far toward

breaking the spiral of Federal spending and bringing order to our fiscal affairs. The proposed budget would limit the rise of spending in fiscal 1977 to 5-1/2 per cent, compared with an average yearly increase of 12 per cent over the previous five years. The Federal deficit is projected to decline from \$76 billion in the current fiscal year to \$43 billion in the next, with a balanced budget finally in view by fiscal 1979.

Some well-meaning citizens are now urging the Congress to provide added fiscal stimulus in the interest of speeding the return to full employment. I would warn this Committee that still larger Federal expenditures and a bigger deficit may fail of their purpose. A deeper deficit would require the Treasury to rely more heavily on credit markets, thus drawing on funds badly needed for homebuilding and for business capital formation. Worse still, a significantly larger deficit would revive fears of accelerating inflation, and weaken the confidence of businessmen and consumers that is essential to the return of general prosperity.

Moderation in monetary policy is also needed to bolster confidence in the economic future. That is why the Federal Reserve has been so diligently seeking to foster a financial

climate conducive to a satisfactory recovery, but at the same time to minimize the chances of rekindling inflationary fires.

Since last spring, growth rates of the major monetary aggregates -- while varying widely from month to month -- have generally been within the ranges specified by the Federal Reserve in its periodic reports to the Banking Committees of the Congress. On a seasonally adjusted basis, the quarterly average level of M_1 -- that is, currency plus demand deposits held by the public -- rose over the last three quarters of 1975 at an annual rate of 5.7 per cent. M_2 , which also includes time and savings deposits at commercial banks other than large certificates of deposit, rose at a rate of 9 per cent. A still broader monetary composite, M_3 , which also includes deposits at thrift institutions, rose at a rate of 12 per cent.

These increases in the monetary aggregates were accompanied, as we expected, by a sharp rise in the turnover of money balances. The rising velocity of money has not, however, been associated with higher rates of interest or developing shortages of credit -- as some critics of Federal Reserve policy had predicted. On the contrary, conditions in financial markets have continued to ease, and are more comfortable now than at any time in the past two years.

There is a striking contrast between the movement of interest rates during the current recovery and their behavior in past cyclical upswings. Short-term interest rates normally begin to move up at about the same time as a recovery in general business activity gets under way, although the degree of rise varies from one cycle to another. In the current economic upswing, a vigorous rebound of activity, a continuing high rate of inflation, and a record volume of Treasury borrowing might well have been expected to exert strong upward pressures on short-term interest rates. In fact, after some runup in the summer months of last year, short-term rates turned down again last fall, and since then they have declined to the lowest level since late 1972. Long-term rates have also moved down; yields on high-grade new issues of corporations are now at their lowest level since early 1974.

Conditions in financial markets thus remain favorable for economic expansion. Interest rates are generally lower than at the trough of the recession. Savings flows to thrift institutions are still very ample, and commitments of funds to the mortgage market are continuing to increase. Mortgage interest rates are therefore edging down.

Moreover, the stock market has been staging a dramatic recovery. The average price of a share on the New York Stock Exchange at present is about 60 per cent above its 1974 low. A large measure of financial wealth has thus been restored to the millions of individuals across our land who have invested in common stocks. Besides this, the advance in stock prices has made it considerably easier for many firms to raise equity funds for new investment programs or for restoring their capital cushions.

In general, the liquidity position of our Nation's financial institutions and business enterprises is now much improved. Since the beginning of 1975, corporations have issued a record volume of long-term bonds, and they have used the proceeds to repay short-term debts and to acquire liquid assets. Commercial banks have reduced their reliance on volatile funds and added a large quantity of Federal securities to their asset portfolios. The liquidity position of savings banks and savings and loan associations has likewise been strengthened.

The market for State and local governmental securities was, of course, adversely affected by the New York City financial crisis. Even in this market, however, interest rates are now well below their 1975 highs, and the volume of securities

issued has remained relatively large. The difficulties of New York City, moreover, have had a constructive influence on the financial practices of State and local governments -- as well as on the other economic units -- throughout the country. The emphasis on sound finance that is now underway enhances the chances of achieving a lasting prosperity in our country.

These notable accomplishments in financial markets indicate, I believe, that the course of moderation in monetary policy pursued by the Federal Reserve over the past year has contributed to economic recovery. The Board was pleased to learn that the Senate Banking Committee, in its recent "Report on the Conduct of Monetary Policy," agrees with this view.

Last spring, when the Federal Reserve first announced its projected growth ranges for the monetary aggregates, concern was expressed by some economists, as well as by some members of Congress, that the rates of monetary growth we were seeking would prove inadequate to finance a good economic expansion. Interest rates would rise sharply, it was argued, as the demand for money rose with increased aggregate spending, and shortages of money and credit might soon choke off the recovery.

We at the Federal Reserve did not share this pessimistic view, and our judgment has been borne out by experience. We knew that the turnover of money is apt to increase rapidly with a return of confidence. We knew also that financial technology has been changing, that the innovative process has accelerated of late, and that significant economies in the handling of cash balances were therefore being effected.

The developments that have recently fostered economizing on the sums held as currency or demand deposits include the spread of overdraft facilities at banks, increased use of credit cards, the growth of NOW accounts in New Hampshire and Massachusetts, the emergence of money market mutual funds, the development of telephonic transfers of funds from savings to checking accounts, and the growing use of savings deposits to pay utility bills, mortgage payments, and other obligations. One very recent development that has had a considerable downward influence on the level of demand deposits was the regulation issued by the banking agencies last November, which enabled partnerships and corporations to open savings accounts at commercial banks in amounts up to \$150,000.

The relatively slow rate of growth in demand deposits since last summer has been watched carefully by the Federal Reserve. In view of the rather rapid pace of economic expansion, the relative ease of financial markets, and the absence of any evidence of a developing shortage of money and credit, we have been inclined to view the sluggish rate of expansion in M_1 as reflecting the influence of various factors that are reducing the amount of narrowly-defined money needed to finance economic expansion. However, since it is practically impossible to project the scale on which further economies may be realized, we have taken steps to ensure that the rate of monetary expansion does not slow too much or for too long.

During the past few months, open market policies have therefore been somewhat more accommodative in the provision of reserves to the banking system. In January the discount rate was lowered from 6 to 5-1/2 per cent. And on two occasions -- in mid-October and again in late December -- the Board reduced reserve requirements. These reductions were aimed principally at encouraging a further lengthening of the maturities of time deposits at member banks, but they also released nearly \$700 million of reserves and thus enabled banks to support a higher level of money balances.

These actions appear to be bearing fruit. In January and February, taken together, growth of M_1 moved up to an annual rate of about 5-1/2 per cent, compared with 2 per cent in the fourth quarter of last year. And the annual growth rate of M_2 over the past two months has accelerated to 13 per cent.

Our objective is to stay on a course of monetary policy that will continue to support a good rate of growth in output and employment, while avoiding excesses that would aggravate inflation and create trouble for the future. As I indicated in testimony before the House Banking Committee last month, the Federal Open Market Committee has projected growth ranges of the monetary aggregates for the year ending in the fourth quarter of 1976 that differ only a little from those announced previously.

We believe that the monetary growth ranges we have projected will prove adequate to finance a good expansion of economic activity in 1976. But the uncertainties that at present surround monetary developments, particularly the behavior of M_1 , will require a posture of exceptional vigilance and flexibility by the Federal Reserve in the months ahead.

Before closing, I would remind this Committee that fiscal and monetary policies alone cannot be expected to achieve

our economic goals in the current economic and financial environment. It is not enough to ask what further fiscal stimulation, if any, or what further monetary stimulation, our economy requires. Nor is this even the basic question. We should rather be asking what governmental policies, covering as they might an enormous range of actions and even inactions, are most likely to strengthen the hope and confidence of our people. In the time remaining, let me briefly comment on some policies, outside the monetary and fiscal area, that can make a significant contribution to the restoration of full employment and also to correcting the long-run inflationary bias in our economy.

First, governmental efforts are long overdue to encourage improvements in productivity through larger investment in modern plant and equipment. This objective would be promoted by overhauling the structure of Federal taxation, so as to increase incentives for business capital spending and for equity investments in American enterprises.

Second, we should face up to the fact that environmental and safety regulations have in recent years run up costs and prices and have held up industrial construction across our land. Progress toward full employment and price stability would be

hastened by stretching out the timetables for achieving our environmental and safety goals.

Third, a vigorous search should be made for ways to enhance price competition among our business enterprises. The Congress is to be commended for putting an end to the so-called fair-trade laws. It would be desirable to go further and reassess the entire body of laws directed against restraint of trade by business firms and to improve the enforcement of such laws. We also need to reassess the highly complex governmental regulations affecting transportation and the many other laws and practices that impede the competitive process.

Fourth, governmental policies that affect labor markets have to be reviewed. There are grounds for thinking that the Federal minimum wage law is pricing many teenagers out of the job market, that the Davis-Bacon Act is serving to escalate construction costs, and that programs for income maintenance now provide benefits on such a generous scale that they may be blunting incentives to work. High unemployment and numerous job vacancies still exist side by side -- perhaps because job seekers are unaware of the opportunities, or because the skills of the unemployed are not suitable, or for other reasons. Surely, better results could be achieved with more effective job banks,

more realistic training programs, and other labor market policies.

Finally, we need to think through the appropriate role of a limited incomes policy in the present environment. Recent experience has emphatically demonstrated that lasting benefits cannot be expected from comprehensive or mandatory wage and price controls. However, a policy that would permit modest delay in key wage or price increases, thus creating opportunity for quiet governmental intervention or for public hearings and the mobilization of public opinion, may yet be of significant benefit in reducing abuses of private economic power and moving our Nation towards the goal of full employment and a stable price level.

Under current conditions, the return to full employment will have to depend rather heavily on structural policies that serve to reinvigorate competition and release the great energies of our people. Such policies are not, however, a substitute for responsible fiscal and monetary actions. In order to strengthen the confidence of people in their own future and the future of our country, we in government will need to work constructively on all three policy fronts -- fiscal, monetary, and structural.