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Statement by

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before the

Committee on Banking, Housing and Urban Affairs

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It is a pleasure to meet once again with this distinguished Committee on behalf of the Federal Reserve Board. My remarks today will begin with a review of our experience during the first year under House Concurrent Resolution 133; and I shall then turn to the course of monetary policy we consider appropriate for the year ahead.

Last May, when the Board made its first report under the new procedure, the economy was just emerging from the deepest recession of the postwar period. Unemployment was at the highest level in many years, and a large part of our industrial plant stood idle. Prices nevertheless continued to rise at a disconcerting rate. With confidence of consumers and businessmen at a low ebb, the task for monetary policy was clear -- to facilitate a substantial recovery in economic activity, and yet avoid aggravating our problem of inflation.

In that initial report, I indicated that the Federal Reserve anticipated that  $M_1$  -- that is, the money stock defined so as to include only currency and demand deposits -- would grow between 5 and 7-1/2 per cent in the year ahead. For  $M_2$  -- which also includes time and savings deposits, other than large CD's, at commercial banks -- a range of 8-1/2 to 10-1/2 per cent was

specified. For  $M_3$  -- a still broader measure of money balances encompassing, besides the components of  $M_2$ , the deposits at nonbank thrift institutions -- the range was set at 10 to 12 per cent.

When these growth ranges were first adopted, they applied to the year ending in March 1976. Subsequently, because of the erratic movements to which monthly figures on money are subject, the base for measuring the growth ranges was shifted from the level of money balances in a single month to the average level for a quarter.

As time passed, the base periods were moved forward in accordance with the requirements of the Concurrent Resolution. In July 1975, we presented ranges of monetary growth for the year ending in the second quarter of 1976. In October, ranges were adopted for the year ending in the third quarter of 1976. And this January, the ranges were again moved forward to embrace the 12-month period ending in the fourth quarter of this year.

We at the Federal Reserve have viewed these growth ranges as useful guides for the conduct of monetary policy. However, the objective of monetary policy is not to achieve any preconceived growth rates of monetary or credit aggregates, but to facilitate expansion of economic activity and to foster stability

in the general price level. We have therefore stood ready to alter our projected ranges if new developments in the sphere of employment, or production, or prices suggested the need to do so. During this first year under the Resolution, we did not find it necessary to change our annual growth ranges for any such reason.

Some modifications in the growth ranges were advisable, however, because of emerging trends in financial markets. Last October, the ranges for  $M_2$  and  $M_3$  were widened by reducing the lower end of each range by one percentage point. Under credit conditions that prevailed in the late summer and early fall, it appeared that somewhat less growth in these aggregates might be associated with any given rate of expansion in  $M_1$  -- the narrowly-defined money stock. More recently, this January, the range for  $M_1$  also was widened by reducing the lower limit by one-half percentage point. This adjustment took account, among other factors, of the large transfer of funds from demand balances to savings accounts at commercial banks -- a movement occasioned by a regulatory change in November 1975, when commercial

banks were granted authority to offer savings accounts to partnerships and corporations.

These modifications of the monetary growth rates were duly reported to the Congress. Thus, when I appeared before the House Banking Committee in February, I indicated that our range for the year ending in the fourth quarter of 1976 was 4-1/2 to 7-1/2 per cent for  $M_1$ , 7-1/2 to 10-1/2 per cent for  $M_2$ , and 9 to 12 per cent for  $M_3$ . These departures from the initial projected ranges are small, particularly so for volatile financial magnitudes whose relation to economic activity and prices has always been rather loose and imprecise.

Growth rates of the monetary aggregates over the past year have varied from month to month, as they generally do. But as I have noted on previous occasions, even sizable divergences from desired growth rates have little practical significance if they last only a few months. However, when indications develop that the monetary aggregates are likely to move significantly above or below the desired ranges for a sustained period, remedial action by the Federal Reserve may be needed.

Twice in the past year, the System made noteworthy adjustments in its policy instruments to ensure that monetary expansion would, over the longer run, stay on a moderate course.

In May and June of last year, when large Treasury disbursements of tax rebates and special social security checks were made, growth rates of all of the money stock measures soared to extraordinarily high levels. This development did not come as a surprise, but its magnitude was much greater than we had expected from the special Treasury disbursements. Consequently, we set forces in motion around midyear that were designed to return the growth of the aggregates to their longer-run paths. These actions left their mark only temporarily on short-term market rates of interest, but they had a lasting effect on public confidence by confirming the Federal Reserve's commitment to a moderate course of monetary policy.

We also did not hesitate to act later last year when growth of  $M_1$ , in particular, fell well below the desired range. Because 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 were inclined to view the sluggish growth of  $M_1$  during that period as reflecting fundamental changes in financial technology -- changes that were reducing the amount of money needed to finance economic expansion. We also realized, however, that it was impossible to predict with any precision the scale on which

further economies in the use of money might be realized.

We therefore took a series of steps to ensure that the rate of monetary expansion would not slow too much or for too long.

Beginning in the late fall, open market policies became more accommodative in providing reserves to the banking system.

This was reflected in a decline of Federal funds to around 5 per cent. Later on, the discount rate was reduced, and reserve requirements against time deposits were also lowered.

These actions appear to have borne fruit during the past few months. Thus far this year,  $M_1$  appears to have grown at an annual rate of 6 or 7 per cent, compared with a rate of less than 3 per cent over the preceding six months. The influence of the System's somewhat more accommodative policy has shown up also in  $M_2$  and  $M_3$ , both of which have grown at more rapid rates during recent months.

Looking back at the past year as a whole, we find that the pace of monetary expansion was generally in line with the announced ranges. During the twelve months ended in March 1976,  $M_1$  grew by 5 per cent, or at the lower end of the projected range.  $M_2$ , on the other hand, rose by 9-1/2 per cent, which was at the midpoint of its range, while  $M_3$  grew by 12 per cent and was thus at the top end of its range.

The appropriateness of the monetary policy pursued by the Federal Reserve over the past year cannot, however, be evaluated by merely comparing actual rates of monetary expansion with previously adopted ranges. The fundamental questions always are: How well did the economy perform? And did developments in financial markets contribute to the achievement of our Nation's economic objectives? Let me turn now to these basic issues.

When our longer-run growth ranges for the monetary aggregates were announced a year ago, 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 move up sharply, it was argued, as the demand for money and credit 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. We knew from a careful reading of history that the turnover of money balances tends to rise rapidly in the early stages of an economic upswing. We also suspected that changes in financial practices might of themselves be acting strongly to reduce the amount of money needed to support economic expansion. And we

never lost sight of the danger that excessive expansion of money and credit could reignite the fires of inflation and plunge the economy into even deeper trouble.

Subsequent events have borne out our judgment. The Nation's economy has experienced substantial recovery since last spring, financed in large part by increased turnover of existing money balances. During the past three quarters, the physical volume of our Nation's total production rose at an annual rate of 8 per cent, and there is no clear sign as yet of any diminution in the pace of expansion.

The rebound of the industrial sector of our economy has been even stronger. Since its low point in April 1975, the output of factories, mines, and power plants has increased at an annual rate of 11 per cent. The output of nondurable goods already surpasses its previous peak, and of late the production of durable goods has begun to move up briskly. In February and March, the output of durable goods advanced more rapidly than the over-all volume of industrial production.

As the level of business activity rose, the demand for labor strengthened. Employment across the nation has increased

by 2-1/2 million since last spring, and now stands at the highest level in history. The unemployment rate has declined from about 9 per cent to 7-1/2 per cent; the proportion of job losers among the unemployed has diminished substantially; the quit rate in manufacturing has been rising; and the amount of overtime work has increased notably.

The rate of utilization of our industrial plant has also improved. In the major materials industries, only 70 per cent of available plant capacity was effectively used during the first quarter of 1975. By the first quarter of this year, the rate of utilization of capacity in these industries had climbed to 81 per cent. In some individual industries, notably paper and textiles, the rate of capacity use has returned to a level close to the peaks reached during 1973-74.

These gains of production and employment have resulted in higher personal incomes and increased consumer purchasing power. After a long period of decline, the after-tax earnings of workers have increased substantially during the past year in real terms -- not only in nominal dollars. Business profits, too, have recorded large gains.

Throughout this past year, conditions in financial markets have been favorable for economic expansion, and they remain so today. The movement of interest rates during the current recovery contrasts sharply with that observed in past cyclical upswings. Short-term interest rates normally begin to move up at about the same time as the upturn in general business activity, although the extent of rise varies from one cycle to another. In the current instance, with inflation still continuing and the Treasury borrowing at an unprecedented rate, the vigorous rebound of economic activity might well have been expected to exert upward pressure on short-term market interest rates. However, after a brief run-up in the summer of last year, short-term rates turned down last fall, and have since then declined to the level of late 1972. Long-term rates have also moved down; yields on high grade corporate bonds are at their lowest level in more than two years.

Declines in interest rates have extended also to loans from financial institutions. Interest rates have come down on residential mortgage loans. The rate of interest on bank loans to borrowers of the highest credit rating has declined sharply. Rates paid by other bank customers are also lower; in fact, interest rates on loans to small businesses and farmers have fallen to their lowest levels since mid-1973.

Moreover, the stock market has staged a dramatic recovery. The average price of a share on the New York Stock Exchange at present is more than 60 per cent above its 1974 trough. A large measure of financial wealth has thus been restored to the millions of individuals across our land who have invested in common stocks.

Our Nation's business enterprises have taken advantage of the prevailing financial climate to improve their liquidity position. Corporations have issued a huge volume of long-term bonds, and they have used the proceeds largely to repay short-term debt and to acquire liquid assets. For a time, access to public markets for funds was confined largely to firms with the highest credit ratings. Of late, however, some lower-rated firms have found a more receptive public market for their debt issues, and others have met their needs for long-term funds through private placements with life insurance companies and other institutional lenders.

Besides this, the improvement in the stock market has made it considerably easier for many firms to raise funds for new investment programs or for restoration of equity cushions. Nearly \$2 billion of new shares were sold to the public during March. And if the average pace of new stock offerings in

the first four months of this year is sustained, 1976 will see the largest volume of corporate stock flotations in our history.

The market for State and local government securities has also improved since last fall, when the New York City financial crisis made investors cautious and drove up borrowing costs to many States and their political subdivisions. Since then, interest rates on municipal securities have declined, and they are now well below their 1975 highs. New York City's difficulties have had a restraining influence on the financial policies of local and State governments throughout the country; but the volume of new issues of municipal securities has remained relatively large.

The condition of financial institutions has also improved over the past year. Numerous stories have recently appeared in the press about so-called problem banks, but much of this writing has been misleading -- if not altogether inaccurate.

True, some of our banks, particularly the larger banks, got caught up in the euphoria of inflationary developments during the early 1970's and permitted their financial condition to deteriorate. By now, however, these attitudes have decidedly changed. Last year, large banks increased their holdings of liquid assets

by one-third, while reducing sharply their reliance on volatile sources of funds. With greater attention to canons of prudent management, commercial banks also achieved moderate increases in profits -- even in the face of a substantial drain on earnings from increased provision for losses on bad loans. A large share of bank profits was used to bolster capital positions, so that the ratio of capital to risk assets, which had declined steadily during the early 1970's, increased appreciably. Confidence in the banking system has therefore been strengthened, and bank stock prices have been rising along with stock prices generally.

Many banks are still working out special arrangements with real estate investment trusts and other customers who have encountered difficulties in repaying loans. This process will continue for some time. But our commercial banking system is basically sound, its financial condition has improved, and our banks are well prepared to meet increased credit demands as the recovery proceeds.

Other depository institutions are likewise well situated to meet credit demands in the months ahead. Savings and loan associations, in particular, have repaid large amounts of debt

besides adding heavily to their holdings of liquid assets. Furthermore, with savings inflows continuing to be very ample, the thrift institutions have of late become somewhat more aggressive in seeking to expand their mortgage lending. Outstanding loan commitments have risen to the highest level in 3 years; mortgage interest rates have declined, and other terms on mortgage loans - such as downpayment requirements -- are being liberalized.

It is fair to conclude, I believe, that the prudent course of monetary policy that the Federal Reserve has pursued over this past year has improved the state of confidence and fostered conditions in financial markets that contributed to economic recovery. Moreover, a financial base has been laid for a substantial further rise of general business activity.

We may reasonably look forward now to continued expansion of production and employment in the months ahead. Consumer spending, which began to strengthen early in 1975, has been gathering momentum. Retail sales have risen at a faster pace since late last year, increasing 2.8 per cent in March alone. Consumers are now looking to the future with greater confidence -- they are spending a larger fraction of their current incomes; sales of new autos, in fact, have regained the levels of late 1973.

This upsurge of consumer spending has resulted in a substantial decline in the ratio of inventories to sales in many lines of activity. Delivery times are lengthening in some sectors, and businessmen are encountering more difficulty meeting customer needs from stocks on hand. As a consequence, many firms are seeking to rebuild inventories to levels consistent with the faster pace of consumer buying. Taken in the aggregate, stocks of goods have recently begun to rise, and the need for further accumulation will act as a significant stimulus to recovery throughout most of this year.

Residential construction also is moving ahead. Housing starts in February and March were at an average annual rate of 1.5 million units -- about 10 per cent above the level in the fourth quarter of last year, and 50 per cent above a year ago. To date, the rebound in residential construction has been concentrated in single-family homes. But with rental vacancy rates declining, some pickup in the construction of multi-family dwellings may also be expected this year.

Larger expenditures for business plant and equipment also are in prospect. There have been several signs recently of a quickening tempo of activity in the lagging capital goods

sector. New capital appropriations of large manufacturing firms rose sharply during the final quarter of 1975; new orders for nondefense capital goods have now increased three months in a row; production of business equipment has risen briskly during the past 4 or 5 months; and the physical volume of total business investment in fixed capital has increased significantly in each of the past two quarters. With rates of capacity utilization increasing, corporate profits moving up strongly, business confidence gaining, and the stock and bond markets much improved, it is reasonable to expect considerable further strengthening this year in business expenditures for new equipment and new facilities -- as normally happens in the course of a business-cycle expansion.

Our foreign trade balance, however, will probably diminish this year. The volume of exports declined somewhat in the first quarter. Imports, on the other hand, have continued to rise in response to the recovery of our economy, and they now exceed exports once again.

Economic recovery is well under way in a number of foreign countries, notably in Japan, Germany, and France.

The outlook for the over-all volume of international trade thus seems generally favorable. I am, however, concerned about the possible adverse effects on the world economy of recent developments in international exchange markets. The strength of the dollar in exchange markets over recent months is, of course, a tribute to our economy. But abrupt changes in the relative values of national currencies, such as we have been witnessing, add to the risks and the costs of international trade. Worse still, they tend to add to already existing pressures on governments to invoke measures to protect their domestic industries. Fortunately, despite the severe economic problems of recent years, new trade restrictions have been generally avoided.

The countries whose currencies have of late declined steeply in exchange markets are the very ones whose economies are still being damaged by extremely high rates of inflation. In our own country, notable progress has been made over the past twelve to fifteen months in reducing the rate of inflation. The 7 per cent rise in consumer prices last year was about half the increase recorded in 1974. The rise in wholesale prices slowed even more.

In recent months, there has been some further abatement of inflation. The average level of wholesale prices has remained practically unchanged since last October, and the advance in consumer prices during the first quarter of this year was the smallest in several years.

This recent improvement in price performance, however, stems entirely from declines in the prices of foods and fuels -- prices which have tended to move erratically. Meanwhile, the prices of other goods and services are continuing to rise at a troublesome pace, and wages are still increasing much faster than the long-term rate of growth of productivity. The underlying trend of costs and prices thus is still clearly upward, and inflation must remain a major consideration in formulating public policy.

We at the Federal Reserve recognize our responsibility for sticking to a course of monetary policy that will promote further economic expansion, so that our Nation may regain satisfactory levels of production and employment. We also recognize that monetary policy needs to be consistent with an eventual return to stability of the general price level. Our projected ranges for the monetary aggregates in the year ahead have been established with both of these objectives in mind.

The ranges adopted by the Federal Open Market Committee for the year ending in the first quarter of 1977 differ only a little from those announced previously. For  $M_1$ , the projected growth range is 4-1/2 to 7 per cent; for  $M_2$ , the range has been set at 7-1/2 to 10 per cent; and for  $M_3$ , a range of 9 to 12 per cent has been established.

The growth ranges for  $M_1$  and  $M_2$  have been narrowed by lowering the upper end of each range by a half percentage point. The change is small, but it is a logical step in light of developments in financial markets and in the nonfinancial economy.

Our decision to reduce the upper limit of the  $M_1$  range reflects the experience of the past year, when a very moderate rise in the money stock proved sufficient to finance a good economic recovery with declining interest rates. One reason is that the pace of inflation moderated more than might have been expected on the basis of underlying trends of wages and costs. Of larger moment, however, have been the recent advances in financial technology that enable the public to reduce the quantity of checking deposits held for transactions purposes. Further economies in money use are likely in the year ahead, and a reduction of the upper end of the growth range for  $M_1$  therefore seems warranted.

Some downward adjustment in the upper boundary of the growth range for  $M_1$  might have been called for in any event, because a full year of renewed expansion in business activity is already behind us. I have advised the Congress repeatedly that, as every economist knows, the rate of monetary expansion would eventually have to be lowered to be consistent with restoration of general price stability. The adjustment in the projected growth range for  $M_1$  over the year ahead is a very small but prudent step in that direction. Further downward adjustments will be needed as the economy returns to fuller utilization of its labor and capital resources.

Some of the same considerations apply also to  $M_2$ . True, changes in financial technology have had less effect on  $M_2$  than on  $M_1$ , since savings accounts at commercial banks -- which are included in  $M_2$  -- have increasingly come to be used in lieu of checking deposits for transactions purposes. But, as I noted earlier, growth of  $M_2$  during the past year also fell well below the upper end of the range projected earlier. Hence some lowering of the upper boundary of the range appeared to be justified also in the case of  $M_2$ .

Growth of  $M_3$  over the past year has been at the upper end of the range announced originally, thus reflecting heavy inflows of consumer-type time and savings deposits at savings

and loan associations and at mutual savings banks. We cannot be at all certain that these savings inflows will persist at such a rapid pace. We would, however, welcome a continued ample flow of funds to institutions that are major suppliers of funds for homebuilding. Our projected growth range for M<sub>3</sub> has therefore remained unchanged.

The growth ranges of the aggregates adopted by the Federal Reserve for the year ahead represent our present judgment as to the rate of monetary expansion that is consistent not only with continued economic expansion at a satisfactory pace, but also with further gradual unwinding of inflationary tendencies. There are, however, profound uncertainties surrounding the relationships among the various monetary aggregates, and between rates of monetary expansion and the performance of the economy. House Concurrent Resolution 133 recognizes that the Federal Reserve may need to modify its anticipated growth ranges as circumstances change. Let me assure this Committee that we shall report fully to the Congress our actions and the reasons for them.

The Federal Reserve has been pleased by the thoughtful way in which this Committee has dealt with the problems of

monetary policy in its reports on these monetary oversight hearings. We believe that the dialogue between the System and the Congress stimulated by the Concurrent Resolution has been constructive.

This dialogue is just one indication that the Congress is attending seriously and effectively to its responsibilities in the field of economic policy. Another is the concerted effort being made by the Congress to improve its procedures for control of the Federal budgetary process. Evidence of greater financial discipline on the part of Congress is helping to restore the confidence of the American people in their own and the Nation's economic future.

Our country is still faced with many serious economic problems. The menace of inflation is still with us. Unemployment is much too high. Productivity has been lagging. The expansion of our industrial plant is proceeding at too slow a pace. The homebuilding industry and other branches of construction are still depressed. And independence in the energy area is still a distant goal.

Over the past year or so, however, we as a Nation have begun to face up squarely to our major economic problems

and to deal with them more constructively. There is now more reason for hoping that our country will proceed resolutely to establish the basis for a lasting prosperity.

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