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Statement by

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before the

Committee on the Budget

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Mr. Chairman, I welcome this opportunity to meet with the Senate Budget Committee as it considers the Federal budget for fiscal year 1979. The Federal Reserve and the Congress both have important parts to play in shaping the future course of the national economy. Discussions, such as this today, of our economic prospects and problems can enhance mutual understanding and thereby aid in the development of constructive monetary and fiscal policies.

The performance of the economy over the past year or so has been marked by some notable achievements. Gross national product rose 5-3/4 per cent during 1977--about the same rapid pace as we experienced on average in the earlier stages of the current economic expansion. This brisk increase in production made possible a reduction in the over-all unemployment rate of more than a percentage point despite extremely large growth in the size of the nation's labor force. Total employment increased more than 4 million, raising the proportion of our population that is employed to the highest level of the postwar era.

The advance of production and employment last year was broadly based, as most of the major sectors of aggregate demand registered good gains. Consumer spending followed an uneven course during 1977, but for the year as a whole growth was substantial by historical standards. Residential construction continued to provide considerable impetus to expansion, with single-family housing starts reaching an exceptionally high level and multi-family building also posting appreciable gains from earlier depressed levels. Business spending for plant and equipment expanded more rapidly in 1977 than it had earlier

in the recovery, although such investment continued to lag well behind its performance in previous cyclical upswings. And the growth of government spending on goods and services--at both the Federal and State and local levels--also picked up last year.

Although last year's sizable gains in employment and income brought a greater measure of prosperity to millions of American families, we cannot afford to overlook some distinctly negative economic developments that occurred in 1977 and that will require our continued attention in the months and years ahead. As news headlines have highlighted in the past few months, 1977 saw a substantial further widening of our foreign trade deficit and a sharp decline in the value of the dollar in international exchange. Furthermore, the nation continued to suffer from a disturbingly rapid inflation.

The deterioration in our trade balance, which really began more than two years ago, partly reflects the success we have had in rebounding from the deep recession of 1973-1975. As domestic income has recovered strongly, so too has the demand for imported goods. This, of course, includes oil, for which we've become increasingly dependent on foreign sources. Meanwhile, our trading partners by and large have experienced more sluggish economic expansion, and this has both limited their demand for U.S. exports and intensified their interest in penetrating the U.S. market.

The link between the U.S. trade balance and the international value of the dollar is a loose one. In fact, the average value of the dollar in foreign exchange markets rose almost continuously from early

1975 to mid-1976 and then remained steady through mid-1977, even though the U.S. trade position was moving from surplus to substantial deficit throughout this period. Since mid-1977, however, a growing concern about the persistence of our deficit appears to have contributed importantly to the downward pressure on the exchange value of the dollar.

This concern is based in part on the fact that, in contrast to the slower rates of wage and price advance recorded by some other major industrial countries last year, inflation showed no sign of abatement in the United States. Moreover, as one surveys the economic prospects for 1978, it is difficult to be optimistic about progress in curbing inflationary pressures. Because wage increases continued to outstrip gains in output per hour worked, unit labor costs in private industry rose by almost 6 per cent last year, and these higher costs will be feeding through to prices for some time. The recent increase in the minimum wage has added further to labor costs. The same is true of increases in employer contributions for social security and unemployment insurance, although they have some offsetting impact on inflationary pressures through the reduction of the Federal deficit. In addition, the depreciation of the dollar is raising the prices of imports and reducing competitive restraints on domestic prices. And the surge over the past several months in the prices of basic industrial commodities and agricultural products suggests additional upward pressures on the structure of costs and prices.

Even though the outlook for inflation is not bright and must be regarded with concern, prospects for production and employment in 1978 seem generally favorable. It is the Federal Reserve's judgment that trends in the economy favor continued expansion at a moderate rate in real gross national product and a further reduction in the rate of unemployment.

As 1977 drew to a close, aggregate demands for goods and services were strong; final sales in the fourth quarter showed the largest gain of the year. Severe winter weather and the coal strike have caused steep declines in some economic indicators in the past two months; but if there is a prompt resumption of activity in the coal industry, the favorable underlying trends in the economy can be expected soon to reassert themselves. Growth of employment and real disposable income has been strong in recent quarters, and consumer sentiment has remained fairly high. Consumer spending, therefore, is likely to grow at a reasonably good pace. In the business sector, new orders for nondefense capital goods have continued to trend upward, pointing to further expansion in business fixed investment. In addition, the rate of inventory accumulation should accelerate in coming months; inventory investment slowed in the fourth quarter, and stocks are now lean in many product lines. Moreover, with prospects for our exports improved by the likelihood of stronger economic growth abroad this year and by changes in relative currency values, we are hopeful that our foreign trade deficit will not deteriorate further.

Our generally favorable assessment of the outlook for economic activity is also based on our judgment that financial conditions remain supportive of continued economic expansion. Demands for money and credit were exceptionally strong last year. Total borrowing reached record levels--both in dollar terms and as a proportion of GNP. And growth of the monetary aggregates tended to equal or, in the case of the narrow money stock (M-1), to exceed the upper ends of the ranges set by the Federal Reserve.

Recognizing that such rapid monetary expansion--if sustained--would threaten a build-up of inflationary pressures, the Federal Reserve between April and October exerted increasing restraint in the provision of bank reserves relative to the strong demands for them. More recently, in early January, the System fostered a further firming in money market conditions through adjustments in the discount rate and in open market operations--these actions being taken to help stabilize conditions in foreign exchange markets and to emphasize U.S. concern about the integrity of the dollar.

Over-all, since last April short-term market rates of interest have risen about 2 percentage points. Intermediate- and long-term yields also have risen, with the increases largest in the market for Treasury securities, where rates have gone up 3/4 to 1-1/2 percentage points. These increases in yields on long-term securities may well have reflected some increase in the inflation premium, as investors

reacted to the lack of progress in reducing inflation. Nevertheless, despite the increases of the past year, most short-term rates are still less than 1 percentage point above their levels at the beginning of the present economic expansion in early 1975, and corporate and municipal bond yields are significantly below their levels then.

Growth rates for all the monetary aggregates have slackened appreciably, on average, in the last few months. Growth of M-2 and M-3 has slowed in part because the rise in interest rates on market instruments has made them more attractive to some savers than interest-bearing deposits at banks and thrift institutions. At the same time, however, demands for loans at depository institutions have remained strong. Under the circumstances, these institutions have had to supplement their deposit flows by borrowing and by reducing their holdings of liquid assets.

Although these pressures may be causing depository institutions to become a bit more cautious in their lending policies, credit supplies still appear to be ample. Moreover, the financial condition of the key nonfinancial sectors remains generally strong. It is true that household debt burdens, as measured, for example, by the ratio of consumer and mortgage loan repayments to disposable income, are historically high, and they deserve careful monitoring. But to date, there has been no rise in delinquency rates, so that families are thus far handling their increased indebtedness well. Businesses

added further to their liquid assets last year, and corporate balance sheets on the whole seem to be strong, although there is considerable variation from firm to firm. And State and local governments, with record operating surpluses in 1977, appear in the aggregate to enjoy a healthy financial position.

Last week, in testimony before the House Banking Committee, I announced the growth ranges for the monetary aggregates that the Federal Open Market Committee has established for the year ending with the fourth quarter of 1978. The range of increase specified for M-1 is 4 to 6-1/2 per cent; for M-2, it is 6-1/2 to 9 per cent; and for M-3, it is 7-1/2 to 10 per cent. Growth in each of the aggregates is thus expected to be less than was experienced last year. In the judgment of the Committee, these ranges should be consistent with the pattern of economic activity that I outlined earlier--namely, moderate economic expansion, sufficient to produce some decline in the unemployment rate. While it is not anticipated that any significant reduction will be achieved in the rate of inflation this year, the Committee believes that the deceleration in monetary expansion implied by the current ranges will contribute to the ultimate achievement of reasonable price stability.

We recognize, of course, the considerable uncertainties surrounding the shorter-term relationship between growth rates of the monetary aggregates, on the one hand, and the behavior of output and prices, on the other. The Federal Reserve will continue, therefore,

to maintain a vigilant and flexible approach, putting the long-run performance of the economy above the pursuit of any fixed monetary target.

I must emphasize, however, that the solution to the nation's problems of high unemployment and rapid inflation does not rest with monetary policy alone. More stimulative monetary action would perhaps have some positive effect on output and employment for a time, but the resultant intensification of inflationary forces would soon lead to a reversal of those gains. A significantly more restrictive monetary policy, in the face of the strong upward trends built into financial flows by rising costs and prices and the prospective heavy credit demands from the private and public sectors, would run the risk of serious market disruption and economic dislocation. Clearly, other tools of public policy must be marshalled in the effort to improve economic performance.

A major objective of our efforts must be to quicken the growth of labor productivity. Improving labor productivity--besides being the principal source of rising living standards for our people--serves to retard the advance of unit labor costs. This, then, is a key element in slowing inflation and in increasing the competitiveness of U.S. industry in international trade.

Despite some pickup in productivity growth recently--as usually occurs during a business upswing--the longer-term pattern has not been encouraging. During the past decade output per hour worked in the private business sector rose at an average annual rate

of only 1-3/4 per cent, roughly half the rate of advance recorded over the preceding 20 years. A significant cause of this lagging productivity growth has been the poor performance of business capital formation. For many years, the United States has invested a smaller proportion of its total output in new plant and equipment than have most other industrial nations. Though international comparisons are imprecise, it is clear that the share of GNP devoted to nonresidential fixed investment in the United States has been less than half the share allocated in Japan and considerably less than the shares in Germany, France, and Canada as well.

Experience has taught us that substantial investment in plant and equipment is a critical ingredient for longer-term economic growth. Furthermore, an ample capital stock is necessary if we are to avoid production bottlenecks that stifle expansion in output and employment and that aggravate inflationary forces. The encouragement of greater capital spending must, therefore, be an integral part of any comprehensive national policy to achieve full employment, price stability, and a sound dollar internationally. Our efforts in this regard should be directed at both increasing the flow of savings available to private businesses and increasing the willingness of firms to undertake productive investment.

An important step toward assuring an adequate flow of savings to the private sector is the careful management of Government finances.

The record here has not been good. As the members of this Committee well know, the Federal budget has been in deficit every fiscal year but one since 1960. In periods of high unemployment and inadequate total demand, Federal deficits may provide a needed stimulus to aggregate economic activity. As the economy moves toward fuller utilization of its resources, however, Federal deficits become competitive with private capital formation. The Congress has made progress in reducing an evident bias toward deficit spending by establishing improved procedures under the Budget Act of 1974. This Committee, which was created by that Act, has worked hard to exert better control over the Federal budget. I hope that its efforts, in combination with a growing public awareness of the danger of persistent governmental deficits, will prove effective in helping to narrow the gap between Federal outlays and expenditures as full employment is approached.

Along with freeing financial resources for use by the private sector, we must encourage businesses to step up their spending on new plant and equipment. New investments are made when the prospective rate of return is sufficiently attractive and predictable. The traditional Government approach to increasing the rate of recovery of fixed investment costs has been to reduce corporate income tax rates, to accelerate depreciation allowances, and to liberalize the investment tax credit. These policies would help induce an acceleration of capital spending today.

The effect of such actions, however, would be blunted unless measures also are taken to reduce business uncertainty about the future. In the past few years, heightened uncertainty has become a significant impediment to the willingness of businesses to undertake new capital projects. While this uncertainty has a variety of causes, including unresolved tax and energy policies, one important source is the fear of high and volatile future rates of inflation over the life of the investment. Rapidly rising prices bring unpredictable costs and uncertain profit margins; they exacerbate public pressures for controls; and--as we have learned--they increase the likelihood of subsequent recession. It is most difficult for businesses to calculate a rate of return that is acceptable in an environment of rapid inflation. Moreover, inflation also contributes directly to the cost of modernizing and replacing obsolete equipment. With depreciation allowances based on the original cost of equipment, the gap between the original cost and resources available for replacement widens as prices rise.

Our attempts to restrain inflation by using conventional stabilization techniques have been less than satisfactory. Three years of high unemployment and underutilized capital stock have been costly in terms both of lost production and of the denial to many of the dignity that comes from holding a productive job. Yet, despite this period of substantial slack in the economy, we still have a serious inflation problem.

Prudent monetary and fiscal policies are, of course, essential if inflation is to be controlled. But such policies need to be complemented by programs designed to enhance competition and to correct structural problems in particular labor and product markets. And, any program to control inflation would be incomplete without a conscious effort to avoid, where possible, those government initiatives that place upward pressure on prices. There can be little doubt that government has become a significant contributor to the inflationary bias of the economy--not only by incurring persistent budgetary deficits, but also through regulatory and other actions. It is time to search for alternative, less inflationary methods to achieve our social goals.

Mr. Chairman, I have discussed today a number of economic difficulties confronting the nation. However, our history amply demonstrates the resilience and problem-solving capacity of the American people and their economic institutions. The prospects for overcoming our current difficulties thus are promising, if government pursues policies that provide a stable and healthy environment for American enterprise. We must recognize, of course, that results will not come quickly; but if we set our course and pursue it with patience, we can look forward to a better economic future for our nation.