

For Release on Delivery

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

House of Representatives

July 13, 1978

Mr. Chairman and members of the Committee, I appreciate this opportunity to meet with you to convey the views of the Federal Reserve Board on the state of the economy as well as on economic policy issues facing the nation.

The economy is now in its fourth year of expansion and unemployment has been substantially reduced. However, the nation is beset by an unacceptably high and recently accelerating inflation, and budget deficits continue large for this stage of the expansion. It is essential that longer-term policies be structured to confront these problems, while supporting continued growth.

. . PACE OF GROWTH MAINTAINED RECENTLY

Economic growth, though uneven so far this year, has been on the whole satisfactory. As you know, the severe weather and the coal strike temporarily halted over-all expansion during the winter. However, with the subsequent surge in activity--illustrated in the first chart--growth of real GNP in the first half appears to have averaged about a 4-1/2 per cent annual rate, close to the average pace over the first three years of the present expansion.

The vigor of employment growth is one important measure of the underlying momentum of the economy, and indicates that business has confidence in the sustainability of the expansion. The addition of 2-1/4 million jobs so far this year has pushed the unemployment rate substantially lower--as illustrated in the lower panels of the chart--

and supported brisk growth of personal income. Almost all groups of workers have benefited from improved job opportunities, though the unemployment rate remains unacceptably high for minorities and youth.

. . AND THE NEAR-TERM OUTLOOK APPEARS FAVORABLE

Not surprisingly, recent data indicate some slowing from the extremely rapid growth of over-all activity during the spring rebound. Even so, the fundamental determinants of final demand suggest that economic expansion will be reasonably well maintained in the near term.

In particular, consumer demand remains strong. Auto sales continue at extremely high rates following the turnaround that began in March. Some of the surge in durable goods purchases appears to have represented buying in anticipation of further price rises. Gains in retail sales outside the automotive area have moderated somewhat recently, but this was to be expected following the extremely rapid sales pace of February and March. With surveys indicating a continued high level of consumer confidence, sustained moderate growth in income should support further expansion of consumer outlays over the near term.

The business sector also should continue to be a source of support to activity. Inventory policies have been conservative over the past several years, and businesses have in general thus avoided the imbalances that interrupted previous expansions. Various investment surveys, as well as data on equipment orders and construction

contracts, suggest moderate increases in capital spending over the balance of this year.

In contrast, it appears likely that residential construction will cease to be the source of support that it has been in this expansion. While housing activity currently remains at a high level, mortgage markets have tightened considerably and it is likely that residential construction will begin to slacken in coming months. And growth in State and local government outlays is likely to remain modest. These jurisdictions have pursued relatively conservative spending practices and this reluctance to accelerate spending seems unlikely to change, especially in light of tax relief mandated by Proposition 13 in California and the possibility of similar actions elsewhere. But our net export position, which has deteriorated over the past two years, should improve somewhat over the next year. Imports are likely to rise at a slower pace. At the same time, exports should pick up if activity abroad increases as expected and as the changes in exchange rates which have occurred over recent months improve the competitive position of U.S. goods.

. . INFLATION CONTINUES AS OUR BASIC PROBLEM

On balance, the evidence suggests further moderate growth of aggregate demand over the near term, sustaining one of the most durable expansions of the postwar period. But the longer term outlook is clouded by the price situation. During the first three years of the

expansion inflation rates were very high by historical standards, and there has now been a further acceleration of price increases, as shown in Chart 2. So far this year consumer prices have risen at a 10.2 per cent annual rate, as compared to 6.8 per cent in 1977. A key element in the price surge this year has been the adverse developments in the food sector, as meat production has been constrained by an ongoing reduction in the nation's cattle herds. However, prices outside the food area have also moved up sharply recently. Retail prices of nonfood commodities and services rose at an 8 per cent annual rate during the first five months of the year--up appreciably from the 6-1/2 per cent rate in 1977.

We can expect some relief later this year from a slowing of food price increases. But with the economy moving into a period of heavy collective bargaining, the intensified inflation is likely to be reflected in larger wage adjustments, and a more rapid increase in labor costs. These costs also will be boosted early next year by additional mandated increases in social security taxes and in the minimum wage. The continued interplay of wage and price rises, coupled with the legislated cost increases, makes it difficult to anticipate much relief from underlying inflationary pressures over the next year.

. . RISING INFLATION AND RISING INTEREST RATES ARE TWO SIDES  
OF THE SAME COIN

In the last year or so, private and governmental credit demands have risen, putting upward pressure on interest rates.

At the same time, the recent and expected inflation also has been an extremely important factor underlying the increase in interest rates, contributing to money and credit demands and conditioning the stance of monetary policy. Obviously, inflation increases the volume of credit necessary to finance any level of economic activity. Individuals have to borrow more to acquire houses, cars and other durables. In the business sector, the rise in the dollar volume of spending on inventories and fixed capital, a significant portion of which represents rising prices, has outstripped internal funds generation, producing a marked increase in borrowing this year.

In addition to the direct effect of rising prices on credit demands, the prevalent expectation that the rate of inflation will remain extremely high--if not accelerate--has also increased the demand for goods requiring financing. As noted earlier, the extremely strong pace of automobile sales recently appears to have reflected consumer attempts to beat expected price rises. Home sales may have been similarly buoyed by the perception that waiting can only result in having to pay higher prices later. Such purchases have contributed to record instalment debt financing and to substantial additions to mortgage debt. The volume of borrowing also has been strengthened by existing home owners withdrawing part of their rising equity in the housing stock, partly to finance major expenditures and to otherwise maintain living standards in an inflationary environment.

Borrowers appear to be counting on the general rise in nominal incomes that accompanies most inflations to help service their growing debt burden. This, in fact, has been a major ingredient in the upward pressures on interest rates. Borrowers are willing to pay higher interest rates because they expect that their future debt burdens will be eased by rising nominal incomes; meanwhile lenders seek higher interest rates in order to protect their real position.

. . CURRENT BORROWING LEVELS IMPLY FUTURE RISKS

Moreover, such borrowing has contributed to worrisome distortions in the financial positions of consumers and businesses. For example, the ratio of consumer and mortgage loan repayments to disposable income is now at a near record level (Chart 3). Thus far, households have apparently been able to service this debt with little problem. Recently, however, delinquency rates have edged higher, although they remain well below previous peaks. Nonetheless, the level of household indebtedness is of concern, since it may constrain future spending, and could give rise to more widespread financial difficulties--especially if the rate of income growth were to slow.

In the business sector, the pattern of financing has similarly begun to cause some concern. An increasing share of business credit requirements recently has been met through short-term borrowing, especially at banks, and businesses have slowed their accumulation of liquid assets. As a result of these changes in the composition

of business assets and liabilities, corporate liquidity has deteriorated recently, although balance sheets remain in considerably stronger condition than they were in 1974 (Chart 4).

. . RESPONSE OF MONETARY POLICY

While one would expect strong credit demands as a normal counterpart of a healthy and growing economy, a significant--and I am afraid expanding--share of recent credit growth is both the direct and indirect result of inflation. Moreover, mounting inflationary expectations raise the specter of possible speculative excesses, leading to a short-run explosion of credit and output, and subsequently to recession. The Federal Reserve's firming of monetary policy has been designed to minimize the possibility of such an outcome.

In the presence of strong credit demands, the worsening of inflation, and the Federal Reserve's efforts to contain excessive monetary expansion, market interest rates have risen significantly further. Most short-term rates have increased by 1 to 1-1/2 percentage points since the beginning of the year and long term bond yields have followed much the same pattern, as illustrated in Chart 5. The rise of market interest rates has been accompanied by slower growth of savings and small-denomination time accounts at banks and thrift institutions. As a result, growth rates of broader monetary aggregates--M-2 and M-3--have remained within the Federal Reserve's long-run ranges.

The slower rate of growth of savings and small-denomination time deposits has threatened to retard housing activity. Therefore, in an environment of rising interest rates, the Federal regulatory agencies have recently taken action to increase the competitiveness of bank and thrift deposits subject to regulatory ceilings in order to maintain the flow of credit to housing. Two new savings instruments were authorized effective June 1--a variable-ceiling, six-month certificate, with weekly ceiling rates tied to yields on newly issued Treasury bills, and an eight-year certificate carrying ceiling rates of 7-3/4 and 8 per cent for banks and thrifts, respectively. The limited available evidence suggests that these new instruments, especially the defensive six-month certificates, are playing a significant role in helping to sustain net deposit inflows to thrift institutions, even as market interest rates have risen further.

. . CONTINUED HIGH DEFICITS A MAJOR PROBLEM

The persistence of large Federal budget deficits at this advanced stage of our economic expansion is a disturbing problem. Businesses and households have had to compete for funds in credit markets with the public sector, whose borrowing this year has continued at a high level.

During the last recession, large deficits were both a consequence of and a reasonable policy response to the under-utilization of our productive resources. The Federal government cut taxes and increased the size of public employment and other spending

programs. Continued large Federal deficits were justified well into the recovery period, since the expansive impact of Federal fiscal policy was offset in part by sizable budget surpluses by States and localities, together with an increasing foreign sector deficit, both of which drained purchasing power away from the private sector of the economy. Developments this year, however, suggest that the Federal government should be moving with deliberate speed to rein in compensatory policies. The level of private sector activity has risen markedly over the past several years, and there now appears to be much less usable slack in the economy. Moreover, the over-all surplus of States and localities appears likely--in the wake of Proposition 13 in California and related developments--to be swinging back toward balance.

. . WE MUST REDUCE GROWTH OF FEDERAL EXPENDITURES

Positive steps are thus in order to lessen the government's competition with the private sector for resources. The Federal government has a constructive role to play in moderating the ups and downs in economic activity. In the present circumstances, a damper on further expansion of Federal expenditures would help to assure a continuation of sustained long-term economic growth.

In my view, the task of reducing the Federal share of GNP should begin now. A careful, systematic review must be undertaken to reduce or eliminate those Federal programs that are ineffective or that have outlived their usefulness. We also need to recognize the limits on government resources when considering alternative spending proposals.

I believe that we should strive to reduce the Federal government's share of GNP from more than 22 per cent at present to 20 per cent or so over a period of five to seven years. As can be seen in Chart 6, such a reduction would not fully return the government proportion to that of the early 1960's.

As spending is brought under tighter control, government will become less prominent as a borrower in credit markets. A lower government profile will facilitate the flow of credit to the housing sector where it is becoming scarce, and to the business sector where it can be put to use in rebuilding our currently inadequate stock of fixed capital.

. . MEASURES NEEDED TO ENCOURAGE INVESTMENT

Moreover, private capital investment should be encouraged directly by offering incentives to business to expand their stock of plant and equipment. Capital accumulation is the chief engine of long-range growth of labor productivity and rising living standards. Yet for an extended period, the nation's tax policies have not provided adequate incentives for business investment. In particular, depreciation guidelines and the resulting deductions have not approached actual replacement costs in periods of inflation. Present depreciation-tax laws should be liberalized. For example, businessmen could be permitted to use a shorter write-off period for machinery, equipment and structures. Careful consideration also should be given

to present laws that tax corporate profits twice--first at the firm and then at the stockholder level.

Given the neglect of investment which has eroded the nation's capital stock, as well as the need to accommodate to the reality of scarcer and more expensive energy, a larger share of GNP must be devoted to capital investment. It will not be enough simply to reach the investment proportion of 10-1/2 to 11 per cent that has been characteristic of past periods of prosperity and low unemployment. In my opinion, the nation must set an ambitious goal of, say, 12 per cent of GNP for an extended period--a level that would support increased growth and productivity.

. . STRUCTURAL REFORMS ARE ALSO NECESSARY

Establishment of a high-growth, low-inflation economy would be facilitated by extensive reform of costly governmental regulations. Regulatory activities in the health, safety and environmental protection areas may not always achieve the desired outcome at minimum costs, and they need to be reviewed with that thought in mind. Similarly, market- and price-regulation programs should be carefully reexamined to ensure that their benefits outweigh their costs. In this connection, the President's recent executive order to improve the regulatory process is most encouraging and it deserves the fullest possible support and cooperation.

In the same vein, it is important that we carefully consider alternatives for those programs that tend to limit competition and raise prices. Notable examples are import controls, price supports, and the Davis-Bacon and Walsh-Healy Acts. In addition, it seems appropriate to consider deferring the increase in the minimum wage that is scheduled for January 1, 1979, given its implications for costs and for youth employment opportunities.

To conclude, it is my belief that a reduction of budget deficits and restructuring of taxes to help investment, along with prudent monetary management by the Federal Reserve, should, over time, lead to an economy that enjoys sustained growth, price stability and a sound dollar.

Chart 1

# CURRENT ECONOMIC INDICATORS

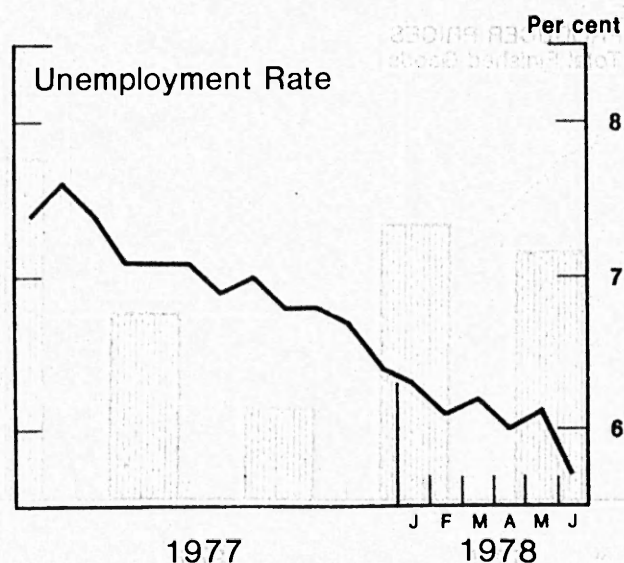
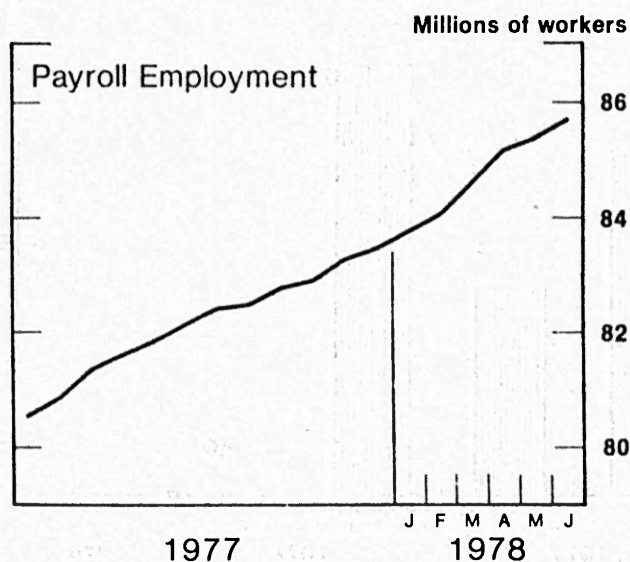
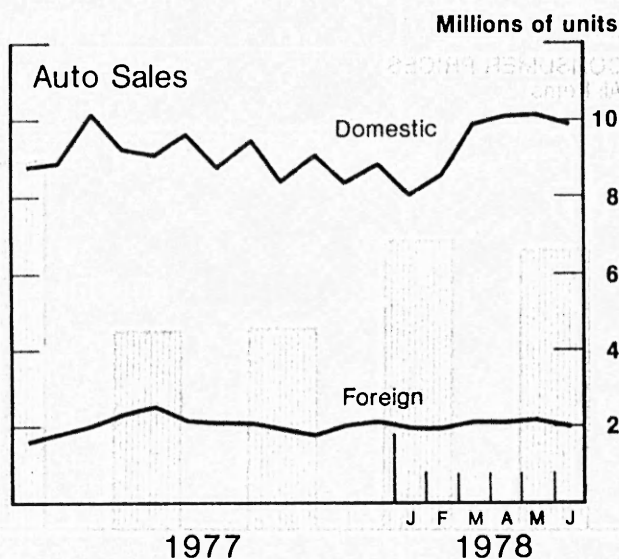
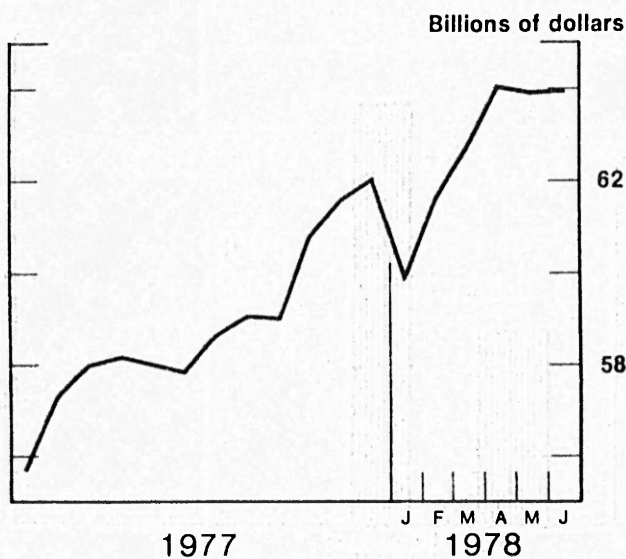
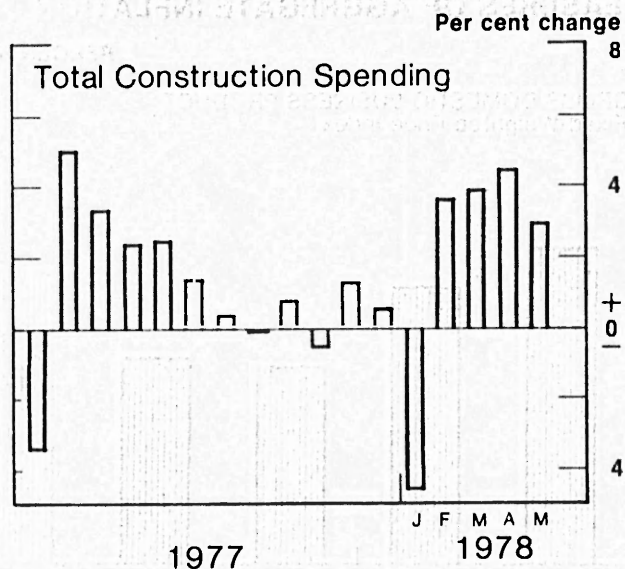
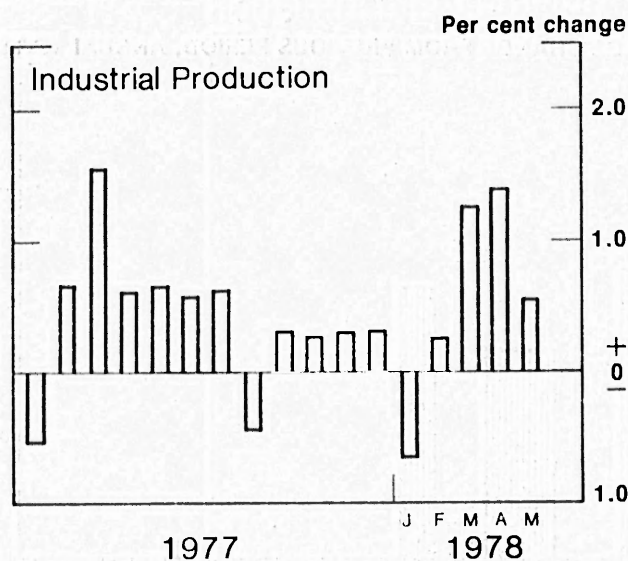


Chart 2

# MEASURES OF AGGREGATE INFLATION

PERCENTAGE CHANGE FROM PREVIOUS PERIOD, ANNUAL RATE

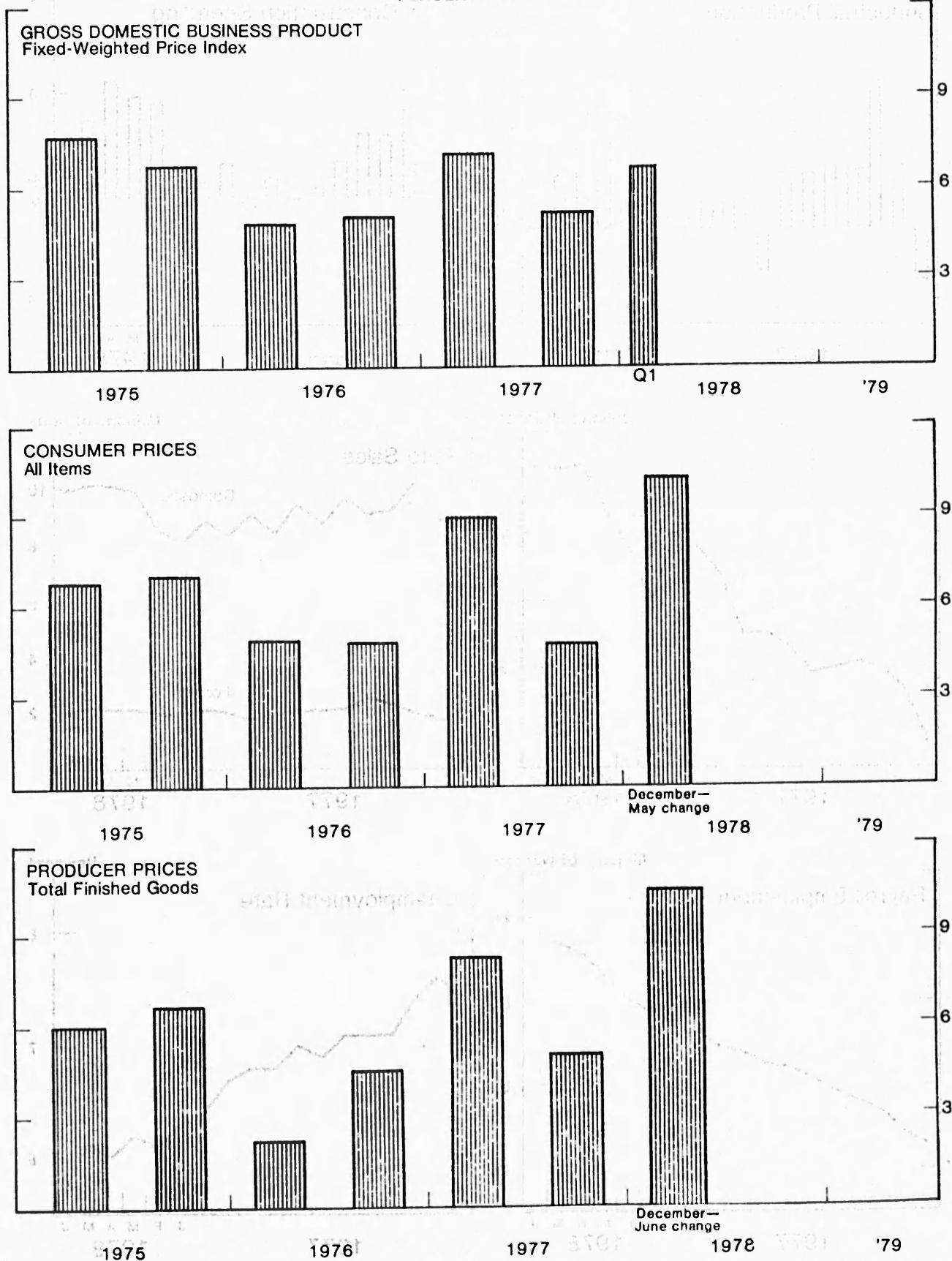
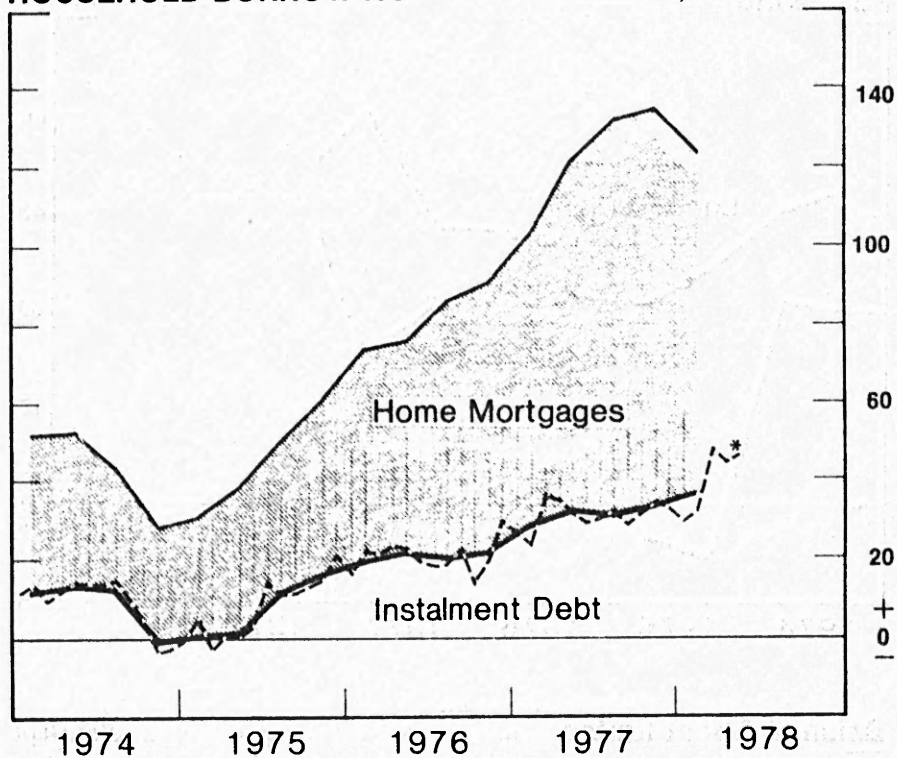


Chart 3

## HOUSEHOLD BORROWING

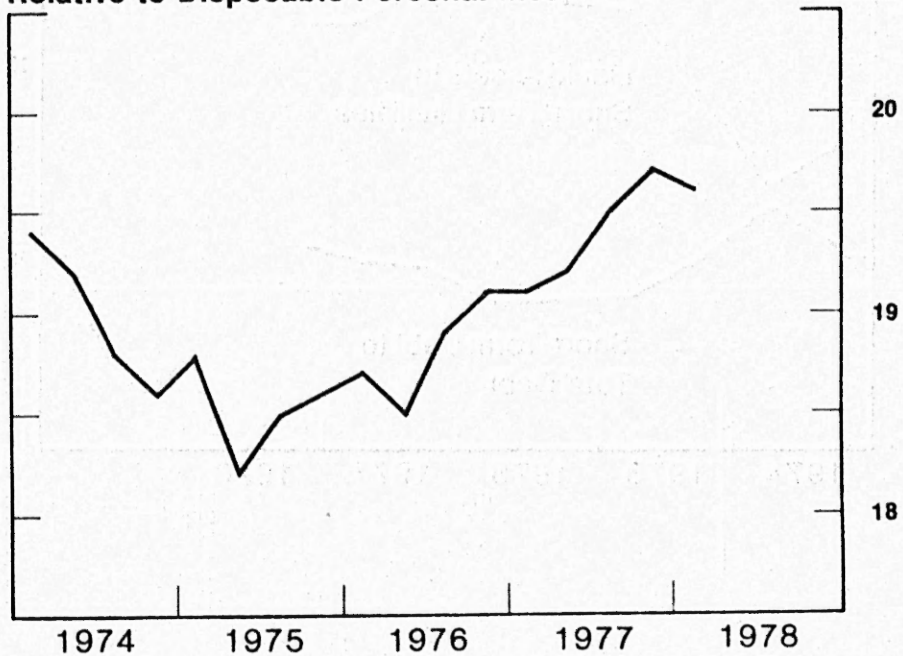
Annual rate, billions of dollars



## HOUSEHOLD DEBT REPAYMENTS

Relative to Disposable Personal Income

Per cent

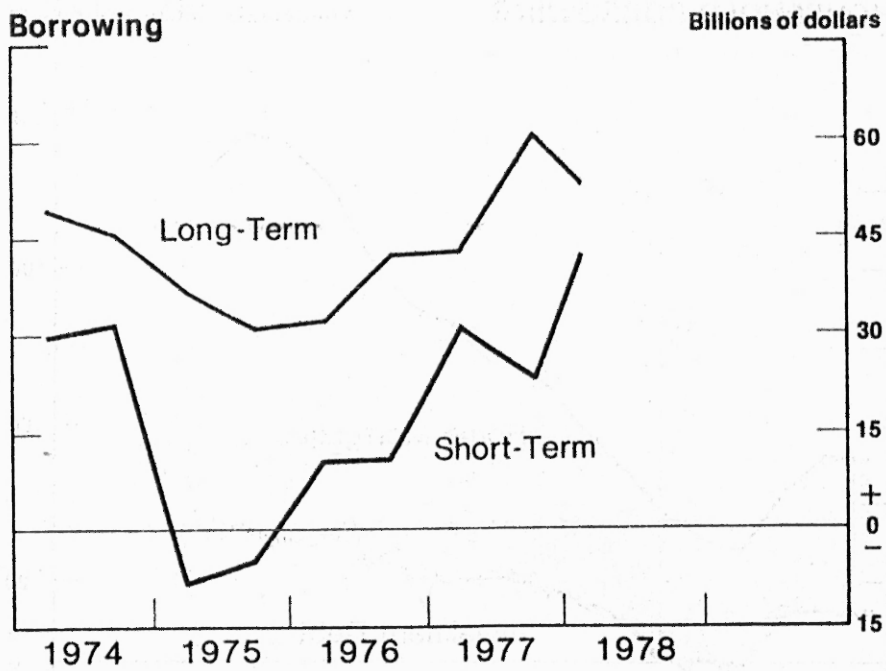


\* Monthly net change in amount outstanding of Total Consumer Instalment Credit.

Chart 4

# CORPORATE FINANCE

## Borrowing



## Balance Sheet Ratios

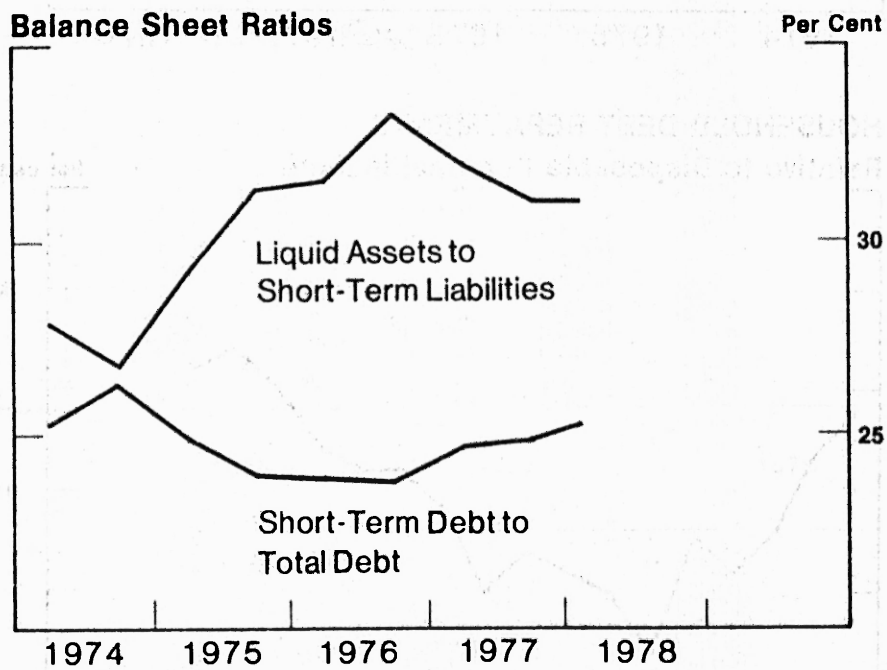
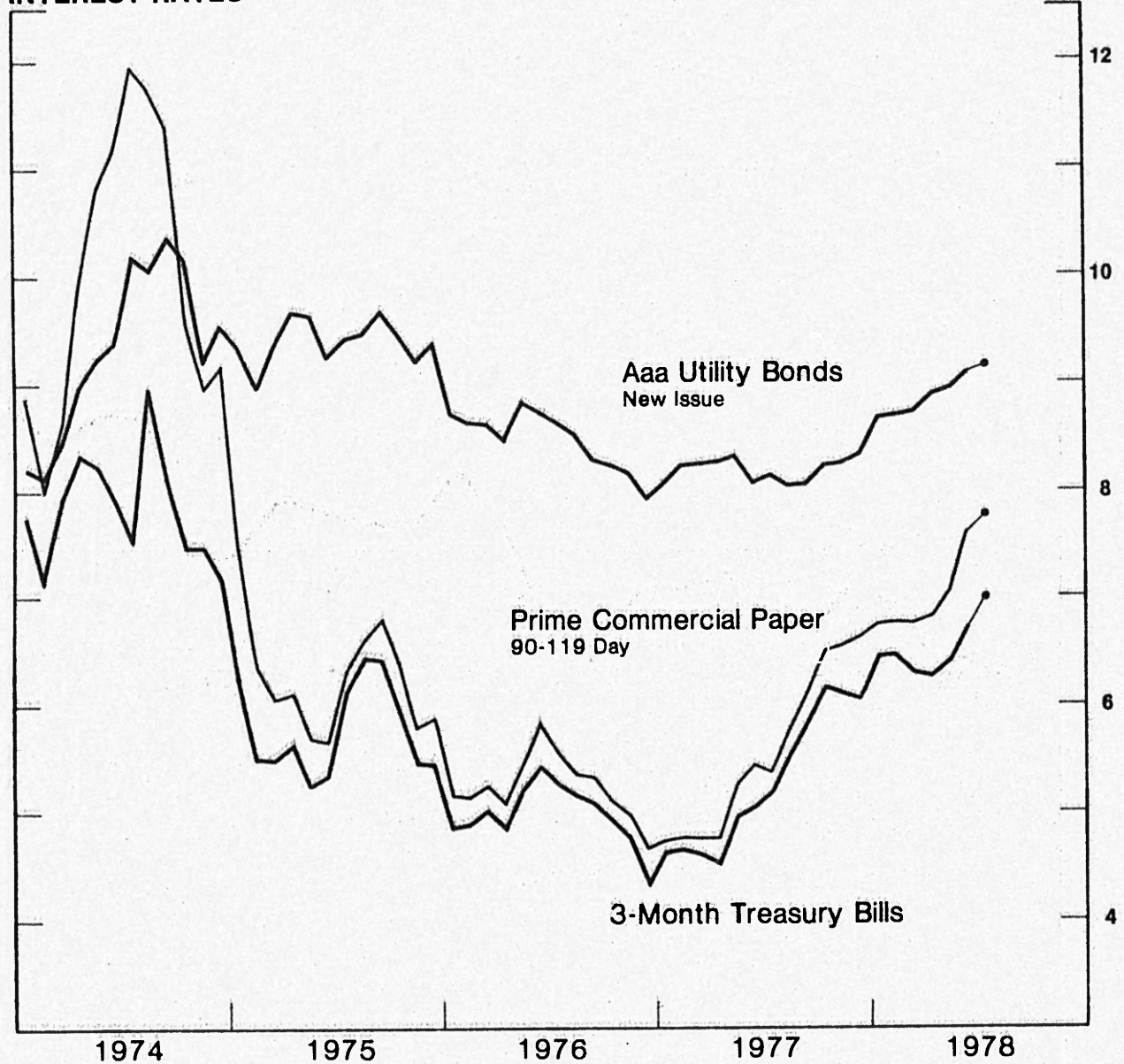


Chart 5

# INTEREST RATES

Per cent



• Week of July 5th

Chart 6

**BUDGET OUTLAYS AS A PER CENT OF GNP**

