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Statement by

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before the

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I welcome the opportunity to discuss with this distinguished Committee the condition of the national economy and the course of monetary policy.

As you well know, our nation is experiencing at present a severe recession. During the past two quarters, the real gross national product has declined by 5 per cent, and the level of industrial production is now 12-1/2 per cent below last September. This is the steepest decline of economic activity in a long generation.

The recession has resulted in a large reduction of jobs and in substantial underemployment of our labor and capital resources. The unemployment rate has risen swiftly, the amount of overtime work has been cut drastically, and the number of employees placed on a part-time basis has also risen.

The recession has been accompanied by a notable degree of moderation in the rate of inflation. Nevertheless, despite the severity of the economic decline, the general price level has continued to advance quite rapidly. In other respects, this recession resembles earlier declines of the past thirty years. Thus, consumer demand for autos, furniture, household appliances, and other durable goods has fallen. Orders or contracts by business firms for new facilities and equipment have likewise declined.

And in this as in earlier recessions, a shift from inventory accumulation to inventory liquidation has been a major depressant of production and employment.

Last fall, business firms were rather slow in reacting to the weakness that had been developing in consumer markets, in part because of their lingering concern about shortages of raw materials and other supplies. As a result, a buildup of inventories -- much of it involuntary -- occurred in the final quarter of 1974. In the opening months of this year, however, as sales to final users stabilized in real terms, liquidation of inventories got underway on a huge scale. Actually, all of the decline in the nation's physical volume of production between the fourth quarter of 1974 and the first quarter of 1975 reflects a shift on the part of the business community from inventory investment to inventory liquidation.

As production declined, much of our industrial capacity was idled, and this has left its mark on commodity prices. Sensitive prices of industrial raw materials had already begun to weaken in the spring of 1974. By late fall the effects of declining business activity began to show up in wholesale prices of intermediate materials, supplies, and components, and later on in prices of finished goods. Since November, the over-all index of wholesale prices has moved down, with farm prices falling substantially and the advance of industrial prices moderating. In recent months, the index of consumer prices has also risen less rapidly than during 1974, and the prices of many products have been marked down in retail markets.

These price developments have served as a significant stimulus to consumer spending. Although after-tax incomes of consumers in the first three months of this year were lower in real terms than in the final months of 1974, consumer purchases -- especially of durable goods -- have perked up in response to price concessions on autos and other items. In fact, consumer expenditures rose in real terms as well as in dollars during the first quarter. Largely for this reason, the efforts of business firms to work down their excess stocks have been notably successful, and inventories are now in better balance with sales.

This has been one of the economic adjustments needed to lay the basis for recovery in production and employment. Other corrective adjustments have also been underway. Business managers have been moving energetically to improve efficiency -- by concentrating production in more modern installations, by eliminating wasteful expenditures here and there, by stimulating employees to work more diligently, and by working harder themselves. Significant progress has also been made in strengthening the financial position of businesses. Exceptionally large amounts of longer-term securities have been issued by corporations this year, and stock offerings have also increased somewhat. A part of the proceeds of these financings has been used to repay short-term debt, thereby improving corporate liquidity.

Financial institutions have also improved their financial condition. Commercial banks have taken advantage of the reduced demand for business loans to repay their borrowings from Federal Reserve Banks, to reduce reliance on volatile sources of funds, and to rebuild liquid assets. At nonbank thrift institutions, the rapidly rising inflow of deposits has likewise permitted a reduction of indebtedness and addition to liquid asset holdings. Thus, financial institutions are now in a better position to meet the needs for credit that will accompany the renewal of economic expansion.

No one can foresee with confidence when an economic recovery will begin. Signs are emerging, however, that the turn in business activity may not be far away.

For example, new mortgage loan commitments by savings and loan associations have risen strongly since last October. Industrial production and total employment fell further in March, but the declines were much smaller than in the previous four months. Prices of sensitive industrial raw materials have stabilized recently, as supply and demand have come into better balance. Sales of goods at retail -- apart from autos -- rose further in March. Of late, consumer surveys have indicated some improvement in confidence. And stock prices, another indicator of confidence, have continued to rise briskly.

Prospects for an upturn in economic activity have also been strengthened by passage of the Tax Reduction Act of 1975. The large rebate of 1974 tax liabilities, the additional payment to social security beneficiaries, and the reduction in withholding of 1975 taxes will soon add to disposable incomes and bolster consumer spending. Larger consumer buying will help to stem the erosion in business investment plans, and the liberalization of the investment tax credit will also stimulate business capital outlays. More business investment is urgently needed not only to provide additional jobs, but also to improve the capacity and efficiency of our industrial plants -- thereby contributing to moderation of inflationary pressures.

Let me turn now to the contribution that monetary policy has made to establishing a basis for recovery in business activity.

Once evidence began to accumulate during the summer of last year that economic activity was weakening, the Federal Reserve took steps to ease credit conditions and bolster growth rates of the monetary aggregates. Open market operations became more accommodative, and as the year progressed they were persistently directed towards more ample provision of reserves to the banking system. Other monetary instruments reinforced open market policy. Reductions of reserve requirements of member banks were ordered last September, November, and again this January. The discount rate was also reduced -- once in each month from December through March.

These Federal Reserve actions to augment the supply of loanable funds, together with the weakening of private demands for credit, had a dramatic effect on short-term rates of interest. For example, the Federal funds rate -- the rate banks pay when borrowing reserves from one another -- has declined from a level of about 13-1/2 per cent, registered in July of last year, to about 5-1/2 per cent at present. The interest rate on commercial paper declined from over 12 per cent last July to around 6 per cent. And the prime rate of interest on bank loans to businesses has fallen from 12 to 7-1/2 per cent.

Short-term market rates of interest in the United States fell earlier, more rapidly, and to lower levels than in other industrial countries. Consequently, investors were able to obtain higher yields by shifting funds out of dollar assets into investments in other currencies. These interest-rate differentials help to explain the large decline that occurred in the foreign-exchange value of the dollar between September 1974 and early March this year. During recent weeks, short-term interest rates in foreign countries have declined relative to those here, and the dollar has strengthened in exchange markets.

In the markets for long-term securities, interest rates in the United States have also declined from their previous peaks, although much less than short-term rates. Of course, long-term rates typically fluctuate within a narrower range than short-term rates; but in the present instance, other powerful factors have also been at work. Fears of inflation are still widespread in the business and financial community and long-term interest rates therefore still contain a sizable inflation premium. Moreover, as I noted earlier, corporations have issued an enormous volume of bonds in the past several months, and State and local governments have also borrowed large sums in the capital markets.

More recently, the huge financing demands of the Treasury have become a major disturbing element in the money and capital markets. By the end of this fiscal year, new Federal borrowing -- including borrowing by the off-budget agencies and Government-sponsored enterprises -- will probably amount to over $60 billion. A large part of that total deficit is due to the recession, and it has been financed thus far without undue difficulty because private credit demands have been declining. During the next fiscal year, however, the total deficit will rise to perhaps as much as $100 billion. Participants in financial markets recognize that private credit demands too may be rising soon, and they have therefore become concerned about the strains that may develop in financial markets.

The Federal Reserve has responded to these developing tensions in the capital market by shifting the emphasis in its open-market operations from Treasury bills to longer-term Government securities. Since the end of February, System purchases of coupon issues of the Treasury and Federal agencies have amounted to almost $2-1/2 billion. In view of the limited scope of the market for longer-term Federal securities, this is a very large volume of buying in a short span of time.

These purchases have been helpful in steadying the bond market. But let there be no mistaking the fact that Federal Reserve operations in the market 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. Appreciably lower long-term interest rates are needed now to stimulate economic expansion, but they are unlikely to be attained unless further progress is made in bringing inflation under control.

Success in this endeavor will require more fiscal discipline than we have managed to achieve in recent years. It will also require a course of moderation in monetary policy -- a course that will provide an expansion in supplies of money and credit adequate to facilitate a good economic recovery, but not so large as to rekindle the fires of inflation.

What the Federal Reserve has been trying to accomplish in this regard cannot be understood adequately by focusing on a single measure of money balances. Some observers believe that the Federal Reserve should devote almost exclusive attention to the behavior of the narrowly-defined money supply (M_1) -- that is, currency plus demand deposits -- in the conduct of monetary policy. We in the Federal Reserve do not take so narrow a view of our responsibilities.

The public's demands for currency, for checking deposits, for savings deposits, and for a host of other liquid assets are constantly changing. Financial technology in our country has developed rapidly in the past 20 to 30 years. As a rule, consumers and business firms no longer hold all, or even most, of their spendable funds in the form of currency or demand deposits. More and more corporate treasurers have learned how to get along with a minimum of deposits in their checking accounts. Consumers, too, are learning to keep an increasing part of their transactions and precautionary balances in the form of savings deposits at commercial banks, or shares in savings and loan associations, or certificates of deposit, or Treasury bills, or other income-earning liquid instruments. Moreover, as yields vary, many individuals and business firms have become accustomed to shift their liquid resources frequently among these assets. The result is that no single concept of money now conveys adequately the spendable funds held by the public.

The behavior of the narrowly-defined money supply, M_1, can prove to be a misleading guide to the degree of monetary ease or restraint. For example, in periods of declining economic activity, weakness in transactions demands for cash and in business and consumer demands for credit will tend to slow the growth of M_1. But during such periods market rates of interest usually decline and stimulate faster rates of growth of consumer-type deposits at banks and nonbank thrift institutions.

For example, until recent weeks, the growth of M_1 since last summer has been quite modest. The annual rate of increase in this measure of money was 1.6 per cent during the third quarter of 1974, 4.6 per cent in the fourth quarter, and 3.5 per cent in the first quarter of this year. Over this time span, however, the annual rate of growth of consumer-type time deposits at commercial banks increased from 7.1 per cent during the third quarter of 1974 to 12.7 per cent in the first quarter of 1975. The improvement in deposit inflows to nonbank thrift institutions -- that is, mutual savings banks, savings and loan associations, and credit unions -- was even more pronounced.

During periods of economic expansion, the behavior of M_1 may again be misleading. At such times, large demands for credit and money are likely to strengthen the growth of M_1, but interest rates will tend to rise and thereby curtail the flow of interest-bearing deposits to banks and savings institutions. A monetary policy formulated on the basis of M_1 alone would ignore the pressures of disintermediation that develop in periods of economic expansion, and thus threaten further damage to the mortgage market and to the homebuilding industry.

In an effort to avoid errors of this kind, the Federal Reserve takes into account the behavior of a variety of monetary and credit aggregates in conducting monetary policy. We also pay careful attention to the condition of financial markets -- that is, to movements in interest rates, lending terms, the liquidity needs of businesses and financial institutions, and other variables, including the international value of the dollar, all of which must be given weight in the conduct of monetary policy.

Included with my statement today are four tables. Two show the recent behavior of a number of the principal monetary and credit aggregates, and the others show the recent behavior of the various components of the several measures of money.

Let me describe briefly what is encompassed in each of these money and credit measures. M_1, as I have already noted, includes currency in circulation plus demand deposits at commercial banks. M_2 is derived by adding to M_1 the time deposits at commercial banks other than large-denomination negotiable certificates of deposit (CDs). M_3 is obtained by adding to M_2 the time and savings deposits held at nonbank thrift institutions -- that is, savings banks, savings and loan associations, and credit unions. M_4 is obtained by adding large CDs to M_2; M_5 is derived by adding large CDs to M_3. This last measure, M_5, is the most comprehensive of this group, for it includes the currency holdings of the public plus deposits at all financial institutions. Finally, the credit proxy indicates the funds that member banks of the Federal Reserve System have available for lending, and is thus an indicator of changes in their total loans and investments.

Each of these magnitudes reflects a different dimension of monetary policy. For example, the annualized growth rate of M_1 in the first quarter of this year was 3.5 per cent, as noted earlier. Growth in the credit proxy was marginally lower -- reflecting, in part, an outright decline in the outstanding volume of CDs and nondeposit liabilities of member banks. The other measures of money, on the other hand, show growth rates in the 7 to 10 per cent range, or about as high as in 1973.

Of late, there has been some concern in the Congress and elsewhere that supplies of money and credit were not growing rapidly enough. This judgment, based largely on the behavior of M_1, could have been avoided by taking a more comprehensive view of the economy's needs for money, credit, and liquid assets, and how these needs are met by our complex financial system.

We in the Federal Reserve recognize that the growth rates of money and credit that are appropriate at any moment of time depend on underlying economic conditions. At present, our nation is experiencing very high rates of unemployment and idle industrial capacity. Thus, even though an upturn in business activity may be near at hand, the restoration of full employment of our labor and capital resources will remain a central objective of public policy for many months to come.

The Federal Reserve System is presently seeking a moderate rate of expansion in the monetary and credit aggregates. We believe that the course we are pursuing will promote an increase in M_1 of between 5 and 7-1/2 per cent over the twelve months from March 1975 to March 1976. This is a rather high rate of expansion by historical standards, but it is not too high when idle resources are extensive and financing needs still reflect rising prices.

A growth rate of M_1 in the range of 5 to 7-1/2 per cent would, we believe, be accompanied by higher rates of increase in the other major monetary and credit aggregates -- ranging from 8-1/2 to 10-1/2 per cent for M_2, 10 to 12 per cent for M_3, and 6-1/2 to 9-1/2 per cent for the credit proxy. Increases of this order of magnitude would imply a good inflow of deposits to nonbank intermediaries and a relatively ample supply of mortgage funds.

These rates of monetary and credit expansion are sufficient, we believe, to finance a vigorous economic recovery. If past experience is any guide, the strength of the recovery will depend principally on the willingness of the public to use existing money balances, rather than on the growth rate of the money stock. The first few quarters of a cyclical recovery in business activity typically witness increases in the turnover of money that are much larger than the rate of rise in the money stock. This characteristic of business-cycle experience is of vital importance to monetary policy and must never be neglected.

We recognize that our capacity to foresee the future is very limited, and that our control of the monetary and credit aggregates is imperfect. The growth ranges for the aggregates we have set out to achieve may need to be adjusted in one way or another. New information on economic and financial developments becomes available daily, and the course of monetary policy must therefore be reappraised continuously. In an economy as dynamic as ours, subject to unforeseen developments --

such as a major business failure or a disruption of energy supplies -- the economic and financial outlook can change quickly and dramatically. The Federal Reserve must stand ready to make promptly such adaptations in the course of policy as may be needed to minimize economic and financial difficulties. The Board and the Federal Open Market Committee therefore meet frequently. Thus, while I have given you our present views on the appropriate ranges of growth in the monetary and credit aggregates, these views may need to be modified a month or two from now.

The rates of growth in monetary and credit aggregates presently desired by the Federal Reserve, while appropriate in the present environment, could not 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 be necessary to reduce the rate of monetary and credit expansion, so that the basis for a lasting prosperity is laid.

Let me remind this Committee that the principal cause of the current recession is our earlier failure to bring inflation under control. As the pace of inflation quickened in recent years, the seeds of recession were sown across the economy. Rising prices eroded the purchasing power of workers' incomes and savings. Managerial practices of business enterprises became lax, productivity languished, and corporate profits diminished -- a fact that businessmen were slow to recognize because of faulty accounting techniques. New homes, recreational dwellings, and condominiums were built on a scale that greatly exceeded the underlying demand. Inventories of raw materials and other supplies piled up, often at a reckless pace, as businessmen reacted to fears of shortages and still higher prices. Credit demands, both public and private, soared and interest rates rose to unprecedented heights. Commercial banks became overextended; the quality of loans tended to deteriorate, and the capital position of many banks was weakened.

These basic maladjustments are now being worked out of the economic system by recession -- a painful process that could have been avoided if the inflation had not gotten out of control. Fortunately, the rate of inflation has declined substantially in recent months, but the behavior of prices is still unsatisfactory. The general price level still appears to be rising at a 7 to 8 per cent annual rate; wage increases continue to exceed by a wide margin the long-run trend of productivity; and interest rates remain at high levels by historical standards. The menace of inflation is by no means behind us. Defeat of inflationary forces must therefore remain a major goal of public policy.

The Federal Reserve is firmly committed to do what it can to restore general price stability in this country. The Federal Reserve is also firmly committed to restore full employment in this country.

During the next year, this nation can, and I believe it will, make progress towards the achievement of both of these objectives. The immediate need is to get the economy moving again. But as we go forward, I hope we will be mindful of the damage that has been wrought in our economy by allowing inflation to get out of control, and that we will deal resolutely with the serious longer-range economic problems facing our country. A better measure of discipline is needed in Federal finances. The progressively diminishing fraction of the national income that goes to people who work and invest requires searching scrutiny. Regulatory practices that weaken private enterprise need to be relaxed or scrapped. Ways must be found to stimulate production of energy supplies, to increase incentives for expansion and modernization of productive capacity in other lines, and to strengthen the state of business finances.

Attention to these longer-range problems is essential; for the critical task now facing our country is not only to encourage the process of economic recovery, but also to build a solid foundation for our nation's economic future.

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Table 1
Growth in Measures of Money and Credit
(Seasonally Adjusted Per cent Change, at Annual Rates)

	M1	M2	M3	M4	M5	Credit Proxy
Annually:						
1972	8.7	11.1	13.2	12.5	14.0	11.3
1973	6.1	8.8	8.8	11.6	10.6	10.4
1974	4.7	7.4	6.8	10.8	9.1	10.2
Quarterly:						
1974 I	5.5	9.3	8.9	10.9	10.0	8.2
II	7.0	7.9	6.8	15.4	11.6	20.4
III	1.6	4.5	4.0	6.0	5.1	6.7
IV	4.6	7.0	7.0	9.2	8.6	4.2
1975 I	3.5	8.5	10.3	7.2	9.2	3.1

Note: These percentage rates of growth are calculated from average levels in last months of the annual or quarterly periods. Percentage rates of growth based on quarterly average data would show a somewhat different pattern.

Table 2

Levels of Money and Credit Measures
(Seasonally Adjusted, Billions of Dollars)

		M1	M2	M3	M4	M5	Credit Proxy
Year:							
1972	December	255.8	525.7	844.9	569.7	888.8	406.4
1973	December	271.5	572.2	919.6	636.0	983.4	448.7
1974	December	284.3	614.3	982.5	704.6	1072.8	494.3
Quarterly:							
1974	March	275.2	585.5	940.0	653.4	1007.9	457.9
	June	280.0	597.1	955.9	678.5	1037.2	481.2
	September	281.1	603.8	965.5	688.7	1050.3	489.2
	December	284.3	614.3	982.5	704.6	1072.8	494.3
1975	March	286.8	627.4	1007.8	717.2	1097.5	498.1

Table 3

Growth in Components of Money Stock Measures
(Seasonally Adjusted Per cent Change, at Annual Rates)

	Currency	Demand Deposits	Commercial Bank Time Deposits Other than CD's	Nonbank Depositary Claims 1/	CD's
Annually:					
1972	8.2	8.9	13.5	16.8	31.0
1973	8.3	5.5	11.4	8.9	45.3
1974	10.1	3.2	9.7	6.0	41.5
Quarterly:					
1974 I	11.0	3.8	12.8	8.2	26.3
II	8.2	6.6	8.8	4.9	78.2
III	8.0	-0.2	7.1	3.1	17.2
IV	11.5	2.4	9.0	7.4	25.9
1975	9.4	1.7	12.7	13.1	-2.2

1/ Deposits in mutual savings banks, savings and loan associations and credit unions.

Note: These percentage rates of growth are calculated from average levels in last months of the annual or quarterly periods. Percentage rates of growth based on quarterly average data would show a somewhat different pattern.

Table 4

Levels of Components of Money Stock Measures
(Seasonally Adjusted, Billions of Dollars)

	Currency	Demand Deposits	Commercial Bank Time Deposits Other than CD's	Nonbank Depositary Claims 1/	CD's
Year:					
1972 December	56.9	198.9	269.9	319.1	43.9
1973 December	61.6	209.9	300.7	347.4	63.8
1974 December	67.8	216.6	330.0	368.3	90.3
Quarterly:					
1974 March	63.3	211.9	310.3	354.5	68.0
June	64.6	215.4	317.1	358.8	81.3
September	65.9	215.3	322.7	361.6	84.8
December	67.8	216.6	330.0	368.3	90.3
1975 March	69.4	217.5	340.5	380.4	89.8

1/ Deposits in mutual savings banks, savings and loan associations, and credit unions.