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Statement by

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before the

Joint Economic Committee

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I am pleased to meet once again with this distinguished Committee to present the views of the Board of Governors on the condition of the national economy.

The performance of our economy during the past two years has been disappointing. We have suffered the most damaging peacetime inflation in our nation's history, a critical shortage of energy supplies, and the deepest decline in business activity since the end of World War II.

Signs of faltering in the pace of economic expansion already emerged in the spring of 1973. Homebuilding began to turn down, and so too did sales of mobile homes, new autos, and other big-ticket consumer items. A declining trend in the physical volume of other goods purchased by consumers soon followed.

In the winter of 1973-74, the Arab embargo on oil exports caused some interruption of economic activities. A related and perhaps more ominous development was a quickening of the rate of inflation. The steep rise in oil prices diverted purchasing power to foreign suppliers. Rising prices of consumer goods and services eroded the purchasing power of workers' incomes and savings, and resulted in a further weakening of retail sales.

Inflation also led to a burgeoning of credit demands, both public and private, and interest rates soared.

These developments, however, were largely overlooked by a business community caught up in the euphoria created by inflation. New orders flowing to manufacturers continued to rise, order backlogs generally increased, and stockpiles of materials and other commodities mounted. By the summer of 1974, the physical volume of business inventories was already higher in relation to sales than at any time since the Korean War, but inventories still kept climbing. The stage was thus set for a significant economic adjustment.

Business activity began to decline sharply in the autumn of last year. Between September 1974 and May 1975, industrial output fell by 12-1/2 per cent. As a result, a substantial part of the nation's industrial plant became idle; total employment dropped by 2-1/2 million from its peak in October 1974 to a low in March of this year; the length of the average workweek declined; the rate of unemployment rose from under 5 per cent in late 1973 to perhaps 9 per cent at the present time; and business profits slumped.

The recession has cut deeply into the nation's economic life, but it has at the same time been performing an unavoidable function. Because of neglect of inflation over the previous decade, our national economy was in serious trouble a year ago. Inflation was raging. Industrial commodity prices in wholesale markets were rising at an annual rate of over 25 per cent. Interest rates were at record highs. Not a few financial and industrial firms were encountering difficulties in rolling over their commercial paper or in raising funds through other channels. Cancellations or postponements of corporate bond and stock offerings were announced almost daily. Stock prices plummeted. Fears spread that real estate investment trusts, public utilities, other business enterprises, and even banks might be unable to weather the gathering financial storm. And many millions of American workers, investors, and businessmen became deeply concerned about their own and the nation's economic future.

We have by no means found a satisfactory solution to all the economic and financial problems that troubled us a year ago. Confidence, however, is reviving as a result of the corrective forces that have been at work in recent months.

Thus, business competition is now much keener than it was a year or two ago. Business managers are also devoting more attention to cost control and improvements in efficiency. Prices of industrial raw materials have fallen substantially. Price increases at later stages of processing have also become less extensive. The rise of the general price level has therefore slowed -- from an annual rate of about 12 to 14 per cent late last year to about half that rate recently. Increases of wage rates, moreover, have moderated, although they are still much higher than the long-run rate of increase in productivity.

As industrial activity declined in our country, the need to import industrial materials and other goods diminished. Our merchandise exports, on the other hand, continued to reflect the improvement of our competitive position in world markets during the past two or three years. The foreign trade balance of the United States therefore moved from a sizable deficit in the first half of 1974 to a substantial surplus this year. This development helped to cushion the decline in domestic economic activity, and it also contributed to the strengthening of the dollar in foreign exchange markets since last March. The dollar, I am glad to say, is reestablishing itself as the strongest currency in the world.

In financial markets, the marked improvement in sentiment over the past year has been reflected in a recovery of stock and bond prices. Interest rates on short-term securities declined very sharply. The Federal funds rate -- that is, the interest rate banks pay when borrowing reserves from one another -- fell from a high of 13-1/2 per cent last summer to about 5-1/4 per cent in early June. The commercial paper rate declined from over 12 per cent last July to a low of about 5-1/2 per cent. And the prime rate of interest on bank loans to businesses fell from 12 per cent to a low of 7 per cent.

Interest rates on long-term securities declined much less than short-term rates. 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 among both lenders and borrowers, and long-term interest rates therefore still contain a sizable inflation premium.

As the condition of our money and capital markets improved, so also did the financial position of business firms. Corporations have issued exceptionally large amounts of longer-term securities this year, and they have used much of the proceeds to repay short-term debt or to acquire liquid assets. The liquidity position of consumers has likewise been strengthened; instalment debts to banks and other lenders have been paid down, and many millions of individuals have added substantially to their savings deposits and other liquid assets.

Financial intermediaries, too, have improved their condition. Commercial banks have taken advantage of the reduced demand for business and consumer loans to repay their borrowings from Federal Reserve Banks, to reduce reliance on volatile sources of funds, and to rebuild liquid assets. In their turn, savings and loan associations and mutual savings banks have reduced their indebtedness and enlarged their holdings of Treasury securities and other liquid assets, thus laying the basis for the renewed expansion of mortgage lending during recent months.

The beneficial effects of easier conditions in financial markets, and of the moderation of inflation, began to appear in markets for goods and services while recessionary forces were still spreading. For example, new mortgage loan commitments of savings and loan associations began to turn up in November of last year. By January, sales of new single-family homes were also rising. The backlog of unsold units therefore declined, and residential building began to recover.

In consumer markets, price concessions on autos and other items became common early this year, and retail sales -- especially of durable goods -- expanded. In fact, consumer expenditures during the first quarter rose in real terms as well as in dollars. This upward trend continued in the second quarter, as spendable incomes of consumers were augmented -- first, by tax rebate checks, later by extra social security checks.

With consumer purchases expanding and production declining, the efforts of business firms to work down their excess stocks have been remarkably successful. In the second quarter of this year, inventory liquidation reached an annual rate of around $35 billion -- or about 2-1/2 per cent of the dollar value of the gross national product. This is the largest decline of inventories, relative to the gross national product, in any quarter of the entire postwar period. The rate of production in the second quarter was thus unusually low relative to final sales. With the level of inventories in most consumer lines now in rather good balance with sales, the base has been laid for a recovery in aggregate economic activity.

Correction of the economic and financial imbalances of a year ago has resulted, in large part, from the internal workings of the business cycle. These self-corrective forces have been aided powerfully, however, by fiscal and monetary policies that sought to cushion the effects of economic adversity, moderate recessionary forces, and provide some stimulus to economic recovery. I need not dwell on the fiscal measures that have been adopted to combat recessionary forces; these measures have already been widely discussed. Let me note merely that I believe the Congress acted wisely in providing only a temporary fiscal stimulus through the Tax Reduction Act of 1975. The confidence of our citizens in the nation's economic future has been bolstered by evidence that responsible members of both the executive and legislative branches of our government are seeking ways to stimulate recovery without releasing a new wave of inflation.

This principle has also guided monetary policy. Last summer, as signs of weakening in economic activity multiplied, the Federal Reserve began taking steps to increase the availability of money and credit. Open market operations were oriented toward a more liberal provision of reserves to the banking system; later, these actions were reinforced by several reductions in the discount rate and in reserve requirements.

During the fall and winter months the demand for credit by businesses and consumers weakened on account of the recession, and commercial banks used the more abundant supply of reserves to repay their indebtedness to the Federal Reserve. Growth in M_1 -- that is, currency plus demand deposits -- was therefore slow to reflect the easing of monetary policy. We at the Federal Reserve were concerned about this development, but we refused to run the risk of releasing fresh inflationary forces and rekindling inflationary expectations. In any event, broader monetary aggregates displayed a more vigorous response to our easing actions. For example, flows of individual savings into commercial banks and thrift institutions began to pick up in the fourth quarter of 1974; and by the first quarter of this year, these deposits were expanding at a seasonally adjusted annual rate of over 13 per cent.

Federal Reserve actions to increase the availability of reserves take some time to work their way through the economic system. As a consequence, some of the effects of easier Federal Reserve policies during a recession may not register in M_1, the narrowly-defined money stock, until the demand for transactions balances begins to strengthen. That may well have been a factor in the huge bulge of the money supply during May and June of this year. However, a large part of this bulge was also the direct result of the tax bill passed earlier this year by Congress. The tax rebate checks and supplemental social security payments disbursed by the Treasury were temporarily added to the public's holdings of currency, demand deposits, and savings accounts. Thus, M_1 grew at an average annual rate of 14-1/2 per cent during the months of May and June, and M_2 -- which includes consumer-type time deposits at commercial banks, besides currency and demand deposits -- increased at a rate of about 16 per cent. By late June and early July, as individuals disposed of their additional funds, the explosion of the monetary aggregates subsided.

Over the past three quarters as a whole -- that is, during the period of steeply declining business activity -- the additions to money and credit supplies have been on the generous side for an economy that is continuing to suffer from inflation. In fact, the growth rates of the monetary aggregates during this recession have been appreciably higher than during comparable periods of earlier postwar recessions. The narrowly-defined money stock, M_1, increased at an annual rate of about 5% from the third quarter of 1974 to the second quarter of this year. Increases in broader measures of money balances were considerably larger over this period. For example, M_3 -- which includes all consumer-type time deposits at depositary institutions, in addition to currency and checking accounts -- rose at an annual rate of 9% over the three quarters. As these facts indicate, Federal Reserve policy contributed materially to establishing the financial basis for an upturn in business activity.

In recent weeks, signs have multiplied that the economy is moving through a turning zone from recession to recovery. Improved markets for consumer goods have been leading the way, with retail sales gaining strength progressively since early this year. The appreciable pickup in new auto sales over the past several months is continuing, and so is the uptrend in sales of residential real estate. Sales of new houses in May were 50 per cent above their trough last December, and the backlog of unsold units is down to eight months' supply at recent sales rates.

With excess inventories at retail, wholesale, and manufacturing firms being worked off and the curve of consumer sales still rising, businessmen have become more optimistic about the future. New orders for durable goods -- an important leading indicator of industrial activity -- have risen in each of the past three months. Moreover, industrial production, after declining in eight consecutive months, registered its first advance in June.

In the labor market, too, there are numerous signs of improvement. The range of nonfarm industries adding to their payrolls has been widening steadily, from a low of 17 per cent in February to about 50 per cent in May and June; total employment has increased by 600,000 over the past three months; the average factory workweek has lengthened; and of late, initial claims for unemployment insurance have dropped substantially.

We may be reasonably confident, therefore, that a recovery in business activity will develop soon, if it is not already underway. Inventory liquidation in some lines -- particularly among producers of capital equipment -- seems likely to continue for a time, and an upturn in business fixed investment may lag behind the expansion in general economic activity. In many sectors, however, the need to rebuild stocks in response to improving sales will add a strong upward thrust to industrial production and to employment in the months ahead. As uncertainties about jobs and earned incomes abate, consumer spending will advance further. A significant rise in residential building activity may also be expected, since the underlying improvement in the condition of real estate markets has just begun to register in rising new home construction.

Tne outlook for our foreign trade balance, while less clear, also appears to be favorable. To be sure, recent trade surpluses reflect in part the impact of the decline in domestic activity on our imports -- especially of fuels and industrial supplies. A revival of economic activity here will tend to boost these imports; but once foreign economies begin to recover, which seems likely before the year comes to an end, our exports of industrial materials will also pick up. Exports of machinery have been maintained at a high level this year, despite the weakness of foreign economies; these exports may be expected to do well over the next year. And in view of unsatisfactory harvests abroad, our exports of grain will be large -- perhaps even embarrassingly large.

Recovery from the recession of 1974-75 thus seems likely to be broadly based. How strong the recovery will be, no one can foresee with any assurance. The amounts of idle labor and capital resources are certainly sufficient to permit rapid growth over the next several quarters. Past cyclical experience suggests, moreover, that a steep decline in business activity such as we have experienced is usually followed by a brisk recovery.

We must recognize, however, that our economy is confronted with some troublesome problems to which public policy must attend if full employment is to be regained. Energy prices are extraordinarily high, and they may well rise further. Shortages of energy supplies and other industrial materials could become a serious impediment to the expansion of production and jobs in a year or two. Our financial markets, meanwhile, will have to absorb a huge volume of Treasury securities this fiscal year -- at a time when private credit demands will be expanding to finance larger economic activity. To make matters worse, inflation is still adding its own dimension to pressures in financial markets.

The vigor of economic expansion in the year ahead, and even more over the next few years, will depend heavily on the ability of our government to find ways to cope with these difficulties. Let me therefore turn to the implications of these problems for public policy.

As far as the Federal Reserve is concerned, the only responsible policy is to pursue a moderate course of monetary and credit expansion, such as I described before the House Committee on Banking, Currency and Housing a few days ago.

The relation over time between money balances and the physical volume of economic activity is rather loose, since so much depends on the attitudes of businessmen and consumers as well as on other governmental policies that are pursued simultaneously. But with M_1 growing in a range of 5 to 7-1/2 per cent, and more comprehensive measures of money expanding substantially faster than this, it should be entirely possible to finance a recovery of normal cyclical dimensions over the next year. History teaches that the turnover of money -- that is, the willingness of people to use their existing money balances -- tends to rise much faster in the recovery stage of the business cycle than does the monetary stock itself. This basic fact about the business cycle must never be overlooked in judging the reasonableness of monetary growth rates.

I might add that materially higher or lower monetary aggregates than the Federal Reserve has projected for the coming year would involve serious risks. If, for example, the expansion of M_1 were held down to 3 or 4 per cent, short-term interest rates might rise rapidly and impede economic recovery. On the other hand, if a growth rate of 8 or 10 per cent were sought, inflationary expectations would be intensified, and larger increases in prices and costs would be encouraged. In these circumstances, long-term interest rates would tend to rise, since investors would insist on getting, and borrowers would be willing to pay, a higher inflation premium. It is highly important to bear in mind the longer-run effects of the policy alternatives now available to the Federal Reserve. More rapid monetary growth would indeed tend to hold down short-term interest rates and thus impart some immediate stimulus to economic activity. But long-term interest rates would soon rise and perhaps frustrate any reasonable prospect of recovery in housing or business capital investment.

As I noted earlier, the growth of monetary aggregates in recent months has been well above the longer-run rates of expansion that we have been seeking. The Federal Reserve has no intention of permitting rates of increase as high as those in the second quarter to continue. The special Treasury disbursements have come to an end; and we have already set in motion forces that should, in the near future, return the growth of the monetary aggregates to the moderate path desired. These recent actions have left their mark, if only temporarily, on short-term market rates of interest. But if that had not occurred, the business and financial community, which nowadays is highly sensitive to monetary growth rates, might well have concluded that the Federal Reserve is releasing a new wave of inflation. Any such interpretation by market participants could have had damaging effects on economic prospects at this stage of the business cycle.

As I believe this Committee recognizes, the growth ranges for the monetary aggregates that we have projected for the next twelve months may need to be adjusted one way or another. Clearly, the growth rates presently sought by the Federal Reserve, while appropriate in the present environment of high unemployment and unused industrial capacity, could not be maintained indefinitely without giving up the fight against inflation. 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.

Timely steps may also be needed to reduce the degree of fiscal stimulation as economic recovery proceeds. The gigantic budget deficits for fiscal 1975 and 1976 -- coming on top of the persistent Federal deficits of the past decade -- are a major source of the inflationary expectations that are holding up long-term interest rates. When anticipations of inflation are as pervasive as they are today, the only effective device available to the Federal Reserve for holding down long-term interest rates is to pursue a moderate monetary policy. But fiscal policy can also be very helpful in this regard. The American people are awaiting further evidence that their government will restore the fiscal discipline needed to cope with inflation. The Federal Reserve Board therefore urges this influential Committee to use its good offices to press for moderation in fiscal affairs during this and the next fiscal year.

Our country is confronted today with a serious dilemma in its search for ways to move the economy toward full employment. Highly expansionary monetary and fiscal policies might, for a short time, provide some additional thrust to economic activity. But, later on, the rate of inflation would accelerate sharply -- a development that would create even more difficult economic problems than we have yet encountered. The Senate Committee on Banking, Housing and Urban Affairs has recognized this basic truth. Its recent report on monetary policy states unequivocally that "if inflation is rekindled, any recovery will be short-lived and will end in another recession, one almost certain to be more virulent than the present one."

In the current economic and financial environment, conventional thinking about stabilization policy is insufficient. We need to reopen our economic minds and actively seek ways of achieving reasonably full employment without resorting to ever larger monetary and fiscal stimuli.

A part of our recent problem of continuing inflation amidst widespread unemployment stems from a failure to attend sufficiently to modernization and improvement of our nation's industrial plant. Our country has been devoting relatively less of its economic resources to business capital expenditures than any other major industrial nation in the world. The result has been a diminishing rate of increase in productivity, the emergence in 1973 and 1974 of severe shortages of critically-needed industrial materials and supplies, and continuing upward pressure on costs and prices. Renewed scarcities of major materials -- such as steel, industrial chemicals, and plastics -- could impede the projected economic recovery unless action is soon taken to step up the rate at which modern facilities are expanded in these industries.

The inadequate rate of investment among American enterprises reflects to a large degree the fact that business profits over the last decade have fallen short of the amounts needed to finance a good rate of growth of effective industrial capacity. Last year, the after-tax domestic profits of non-financial corporations -- excluding inventory gains -- were actually smaller than they were eight or ten years ago, when the dollar volume of the output of these corporations was about half what it is today.

The slump of profits, besides its adverse effect on investment, has led to increasing dependence of business corporations on borrowed funds. The amount of debt owed by corporations relative to their equity position has risen sharply for more than a decade, and many businesses therefore no longer have the resiliency they once had to resist economic and financial adversity. There is a clear need in our country not only for larger business capital investment, but also for larger reliance on equity funds in financing capital expenditures.

These objectives may be promoted by an overhaul of the structure of Federal taxation. Value-added taxes are widely used in Western Europe, and it may be instructive to reexamine the merits of such a tax for our country. There are, of course, numerous other possibilities. For example, dividends on preferred stock might be made tax deductible, as the President has recommended, or taxation of dividends that are reinvested in new shares -- at the option of the shareholder -- might be deferred. These and other ways of integrating business and personal taxes deserve thorough study by the Congress.

Another area that needs immediate action is our national energy policy. Uncertainties created by the delay in adopting legislation on the oil pricing problem are becoming a serious obstacle to private economic planning and may increasingly impede the recovery as time goes on. In formulating a national energy program, it is of course necessary to give attention to sources of energy besides oil. Shortages of natural gas are likely to curtail production in some states this winter, and this problem will become more acute in later years if current policies for controlling the price of natural gas are not modified. And let us not overlook the importance of expanding the rate of construction in the electric utility industry. The President's Labor-Management Committee has developed a series of recommendations to accomplish this objective that I hope the Congress will weigh carefully.

Among these recommendations is a suggestion that environmental restrictions be stretched out to facilitate the expansion of electric-generating capacity. Of course, the impact of environmental regulations on the economic activities of our nation goes well beyond the electric utility industry. A good deal of industrial construction across our land is being held up by environmental regulations and litigation. A significant part of business capital outlays, moreover, is now being channeled into equipment for the abatement of pollution, rather than for expanding industrial capacity. For example, in 1974, producers of iron and steel, nonferrous metals, and paper devoted more than 20 per cent of their capital budgets to pollution control. Regulations with respect to the environment and safety have also been a major factor running up auto prices in recent years, and thus putting a damper on auto sales and production.

We at the Federal Reserve are concerned, as are all thoughtful citizens, with the need to protect the environment and to improve in other ways the quality of life. We are also concerned, however, about the vigor of economic recovery and the dampening effect of environmental regulations on business activity. Here, too, a middle ground is needed.

Governmental practices and programs affecting labor markets also have to be reviewed in any serious search for noninflationary measures to reduce unemployment. For example, the Federal minimum wage law is still pricing many teenagers out of the job market. Programs for unemployment compensation at times provide benefits on such a generous scale that they may be blunting incentives to work. Even in today's environment, with perhaps 9 per cent of the labor force unemployed, there are numerous job vacancies -- perhaps because job seekers are unaware of the opportunities, or because the skills of the unemployed are not suitable, or for other reasons. It is hard to believe that better results could not be achieved with more effective job banks, more realistic training programs, and other labor market policies.

Indeed, many structural reforms will prove necessary to enhance the prospects for expanded employment, while at the same time reducing the pressures on costs and prices. We need to gather the courage to reassess our laws directed against restraint of trade by business firms, to reassess the enforcement of these laws, also the monopoly of first-class mail by the Post Office, the various restrictions on entry into the professions, the effects of the Davis-Bacon Act on construction wages and employment, the intricacies of governmental regulation of transportation, the role of trade unions in the public sector, the effects on consumer prices of remaining fair trade laws, and other legislation or practices that impede the competitive process. Nor would I rule out the possibility that some form of incomes policy, going beyond the legislation governing the Council on Wage and Price Stability but continuing to rely mainly on voluntary compliance, may yet be of some benefit in moving our nation towards the goals of full employment and a stable price level.

What I have tried to suggest in these brief comments on structural policies is that we can make better progress in moving toward our national goals by reducing the burden being carried by monetary and fiscal policies. The well-meaning citizens who now keep urging stronger monetary and fiscal stimuli seem to overlook the fact that excessive reliance on such policies brought on an accelerating inflation during the past decade. They overlook the fact that the current recession was caused basically by an inflation that got out of control And they also overlook the fact that a large part of the effort that our nation has directed during the past decade or longer to improving the lot of poor people -- through increases in social security benefits, welfare programs, and other means -- has been nullified by the cumulative force of inflation.

Our nation has paid a heavy price during the past year for tolerating inflation and allowing it to get out of control. All of us in government must now work to ~~promote a good~~ recovery in jobs and production; but all of us must also take great care lest the hard-won gains of the past year be destroyed by a new round of inflation. The rise of the consumer price level in June at an annual rate of over 9 per cent is a warning that the menace of inflation is still very much with us. The task facing our country, therefore, is not only to hasten the process of economic recovery, but also to unwind the inflation and thus lay the basis for a lasting prosperity.

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