Testimony before
House Appropriations Comm.
January 28, 1976

Mr. Burns: Thank you very much, Mr. Chairman. I am not going to try to tell you how to inform your constituents, and I am not going to try to preach a sermon to my fellow economists. I will simply tell you what I think.

I can summarize briefly what I have on my mind and what I would like to convey to this committee in three broad propositions.

First, a good recovery of economic activity is now under way.

Secod, inflation moderated appreciably during the past year, but there is a grave danger that it may accelerate again.

Third, the course of fiscal policy during this year and next will play a decisive role in determining whether or not our country can win the battle against inflation.

Let me turn to the first of these propositions. A good economic recovery has been under way since April or May of last year. The recovery has gathered some momentum; in the second half of 1975 the physical volume of our nation's total production rose at an annual rate of approximately nine per cent. which is a rather rapid rate of increase.

Industrial production -- that is, the output of our factories, mines and utilities -- grew even faster. Between April and December of 1975, industrial production rose at an annual rate of 12 per cent.

These gains in production have been widespread. They started in the nondurable goods fields -- in the production of textiles, leather products, paper products, chemicals. After mid-year, the scope of the expansion in production broadened out and most durable goods lines -- such as the machinery and equipment trades, the metals industry, and the furniture industry -- showed appreciable gains.

The increases in production led to a material strengthening in the demand for labor. Since March of last year, total employment has increased by 1.7 million. The factory work week has lengthened. It is, as of the latest count, one and a half hours longer on the average than it was last March. And the unemployment rate has declined from approximately nine per cent last spring to about eight per cent presently.

As 1975 ended, the economy was moving up at a fast clip. In the month of December, industrial production rose one per cent; employment rose by a quarter of a million; retail sales rose by a remarkable three and a half per cent. In fact, the rise in retail sales toward the end of last year was so rapid that inventories of trade firms actually fell.

Let me try now to speculate a little about the future with you. As I see the economy, there is good reason to expect that the expansion in production and employment will continue in the months immediately ahead. Certainly, inventory restocking will be needed to fill half-empty shelves in many of our firms.

The confidence of consumers is returning. People around the country are in a better mood now; they are spending more freely and the rate of saving, which was remarkably high last year, is diminishing.

Our export markets are strong. As you may have read in this morning's paper, we had a trade surplus in 1975 of $11 billion. Our exports will continue expanding this year, partly because other industrial countries are beginning to recover. Also, prices, by and large, have risen less rapidly in our country than abroad, and American business firms are in a stronger competitive position.

The housing industry, as you know, is depressed, but there has been some improvement and I think there will be gradual further improvement. The backlog of unsold homes is diminishing. Money is certainly in ample supply at our thrift institutions. The inflow of funds to our mortgage lending institutions this January appears to be breaking all records for that month.

Business capital spending, so far, has not shown any convincing signs of recovery. This is not entirely surprising because business investment in fixed capital often lags in the recovery process. But I think that there are cogent reasons for expecting business capital investment to join the recovery process before very long.

As you well know, the stock market has been rising briskly, interest rates of late have fallen rather sharply, and corporate profits have moved up with considerable vigor -- in fact, with unexpected vigor. Also, the utilization rate of our manufacturing industries has been rising. The Federal Reserve Board maintains an index of the rate of capacity utilization of materials-producing industries. That rate was 70 per cent in the first quarter of 1975, and by the fourth quarter it had risen to 81 per cent.

When the overall average rate of capacity use is 81 per cent, there will be some industries that are well above that figure and there will be some firms within individual industries that are higher still.

In sum, with an ample supply of money available, with profits improving, and with the rate of utilization of our factories rising, I think we can reasonably expect that the capital goods industries, before very long, will be showing significant expansion once again.

Our financial markets are now in an excellent position to support further economic recovery. Interest rates have declined over the past six months in contrast to what usually happens in the early stages of a recovery. Usually, interest rates begin rising, and they sometimes rise sharply, at about the same time as economic activity starts to recover. But interest rates now are below their lows of last June; in fact, interest rates on many short-term securities are lower now than they have been at any time since the fall of 1972. The rise in stock prices also favors the continuance of economic expansion. This is making it easier for business firms to raise equity capital. It is also making people feel richer and is thus helping to rebuild confidence all around.

It is also important to note that the liquidity position of our banks, of our thrift institutions, and of our business firms has improved very materially since the spring and summer of last year.

The critical question, of course, is how far and how fast the recovery that is now under way will proceed. In the nature of things, neither I nor anyone else can speak with great confidence on this question concerning the future. But I can say this, with considerable assurance: the strength and the duration of the recovery that we are now experiencing will depend in large part on how well this country does in our continuing struggle with inflation.

Last year we made significant progress. Consumer prices rose seven per cent last year, compared with an increase of 12 per cent during 1974. Wholesale prices rose four per cent last year, compared with 21 per cent during 1974.

But we must not become complacent about the improvement that has taken place on the inflation front, because the progress we made was pretty much concentrated in the first half of 1975, when economic activity was weak. In the second half of 1975, troublesome signs appeared of a quickening in the pace of inflation. Wholesale prices of industrial commodities rose at a nine per cent annual rate, which was more than twice the rate of increase in the first half of 1975. That was a disturbing development. Also, wage rate increases remained rapid last year. As you well know, they have been running far above the long-term rate of improvement in productivity.

If the rate of inflation quickens this year, as may happen, that would pose a threat to the continuance of economic recovery. If the rate of inflation quickens, the restoration of confidence that is now under way would probably soon come to an end. If the rate of inflation quickens, interest rates would rise and financial markets might become unsettled. If the rate of inflation quickens, the flow of funds to our thrift insitutions -- and thus mortgage credit supplies -- would tend to dry up, and housing would suffer grievously once again. Consumer spending would also tend to weaken, because in our times consumers respond to inflation not by spending at a faster rate but by saving at a faster rate. This is one of the important lessons of recent times -- a lesson that as yet is not understood well enough.

In view of what I have said, it seems to me that the task for public policy is eminently clear: we in government must avoid policies that release a new wave of inflation. To the extent that we do so, we will enhance the prospects for a vigorous and durable economic expansion.

Now let me say a word or two about monetary policy. We at the Federal Reserve have been very mindful, not only of the need to expand jobs in our country, but also of the need to moderate the pace of inflation -- because, unless that happens, we will not have good times in our land. We have, therefore, pursued a course of moderation.

During the past year, all of the major monetary aggregates expanded, at a moderate pace. Thus, between the fourth quarter of 1974 and the fourth quarter of 1975, the narrowly defined money supply -- namely, currency plus demand deposits, frequently referred to as M_1 -- rose four and a half per cent. A more broadly defined money supply, which includes also time and savings deposits of commercial banks except for large certificates of deposit, rose eight per cent during that period.

These increases proved to be sufficient not only to finance a vigorous recovery in the physical volume of economic activity; they proved sufficient also, I am sorry to say, to finance a moderately high rate of inflation. Moreover, interest rates fell materially, and this indicates that the moderate rates of expansion in the monetary aggregates were fully sufficient, if not more than sufficient, to take care of the nation's legitimate needs.

We at the Federal Reserve have the firm intention of staying with a course of moderation in monetary policy. Clearly we need continued growth in economic activity; clearly this growth needs to be financed. We expect to provide sufficient money and credit to finance a satisfactory rate of expansion, but we do not have the slightest intention of throwing caution to the winds and of taking the risk of rekindling inflation.

The principles which are guiding monetary policy at the present time should, in my judgment, also shape the course of fiscal policy if our country is to regain any chance of lasting prosperity.

I need hardly remind this committee that since 1960 we have had a deficit in our federal budget every year but one. I need hardly remind this committee that in the ten fiscal years from 1968 through 1977, taking account of the President's recently announced budget, the federal budget deficit will have exceeded $20 billion in six years. And I need hardly remind this committee that in the five years ending with fiscal year 1976, the deficit in the unified budget will have cumulated to about $160 billion. And if we take off-budget outlays into account -- as we should, and as I hope Mr. Lynn soon will -- the total rises to over $180 billion.

The President has recommended a budget for the coming fiscal year which aims to slow down materially the rate of increase in federal spending. Partly for that reason and partly also because of expected increases in revenues, the budget deficit is projected to decline from $76 billion in fiscal 1976 to $43 billion in fiscal 1977.

I would certainly like to see faster progress in reducing the deficit, but I do recognize that the deficit now results in large part from the fact that economic activity is well below the full employment level.

The President's recommendation to cut back on the growth of federal expenditures and also to cut taxes strikes me as sound. Federal expenditures have been growing very rapidly in our country. According to my calculations, last year total governmental expenditures at the federal, state and local levels amounted to something like 38 or 39 per cent of the dollar value of our nation's production. That percentage has been growing progressively over the years. The private sector in our economy is shrinking. We must not overlook the fact that the private sector has been the source of strength and vitality of our economy.

I hope that the Congress will, in general, follow the recommendations in the President's budget message. I am speaking of overall totals, not of the details of the budget.

This committee can serve a vital national function. I trust that you will bear carefully in mind, as you have in the past, the urgent need of this country to follow a course of fiscal prudence and that you, Mr. Chairman, and your colleagues on this committee, will bring your great influence to bear on the thinking of your colleagues on the Budget Committee and on the legislative committees.

Thank you very much, Mr. Chairman.