For release on delivery

Statement by

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before the

Committee on Banking, Currency and Housing

House of Representatives

February 3, 1976

I am glad to meet with this Committee and present once again the Federal Reserve's report on monetary policy.

Last July, when I gave the first report to the Committee under House Concurrent Resolution 133, our economy was just beginning to emerge from the most severe recession of the post-war period. Since then, we have experienced a vigorous economic recovery. According to preliminary calculations, the physical volume of our Nation's total production rose at an annual rate of 9 per cent during the second half of 1975.

The rebound of the industrial sector of our economy has been even stronger. Since its low point last April, the total output of factories, mines, and power plants has increased at a 12 per cent annual rate. The advance was initially most prominent in the textile, leather, paper, and chemical industries, but the scope of the recovery broadened during the fall and winter months and now includes a wide range of durable and nondurable goods.

As production rose, the demand for labor strengthened. Since last spring, total employment across the Nation has risen by 1-1/2 million, and the average factory workweek has lengthened by 1-1/2 hours. In December, the number of employees added to payrolls by our manufacturing industries exceeded the number released by a margin of 3 to 1.

The rate of utilization of our industrial plant has also risen. In the major materials industries, only 70 per cent of available plant capacity was effectively used during the first quarter of 1975; by the final quarter, utilization of capacity in these industries had climbed to 81 per cent.

Nevertheless, a large part of our labor and capital resources still remains idle. Unemployment is still deplorably high, and activity in not a few of our Nation's industries remains depressed. Continuance of moderately rapid expansion is, therefore, essential to the restoration of our economic well being as a Nation.

Fortunately, conditions in the private economy favor a substantial further increase in production and employment this year. Last fall, the pace of advance in economic activity slowed for a very brief period; but a renewed upswing developed toward yearend, and the economy entered 1976 on a strong upward trend. Consumers have been buying more liberally, as is evident from the surge in retail sales late last year. In December, retail sales rose 3-1/2 per cent on a seasonally adjusted basis, and the improvement that developed over the Christmas season appears to have continued thus far this year.

This marked strengthening of consumer spending has resulted in a further liquidation of business inventories, so that ratios of inventories to sales are now unusually low at most retail outlets, and also at manufacturers of nondurable goods. Businessmen have been pursuing very cautious inventory policies; they have been reluctant to reorder in volume until they were confident that recovery was taking hold. As a result, business firms will soon need to rebuild inventories to levels consistent with the improved pace of consumer buying. It should not be surprising if orders and production advance rather briskly in the months just ahead.

Prospects for residential construction also appear to have improved. Prices of new homes remain exceedingly high and this is bound to limit the recovery in homebuilding. Still, the inventory of unsold units -- especially in the single-family market -- has declined, and mortgage credit is now readily available in nearly all parts of the country. Housing starts have therefore been moving up and further significant gains are likely over the course of 1976.

Our export trades, too, will probably register some improvement this year. The demand for exports held up well in 1975, reflecting in large measure the strong competitive position that we have achieved in world markets during recent years. Economic recovery is now under way in other industrialized countries, and as it gathers momentum the demand for our exports should intensify. However, our foreign trade balance is likely to narrow this year, because our economic expansion will lead to an enlarged demand for imports -- including products, such as petroleum and industrial supplies, that fell off sharply during the recession.

Business capital spending can also be expected to contribute to economic recovery during 1976. This sector of demand has yet to show convincing signs of an upturn, but business fixed investment often lags behind other major categories of demand during the early stages of a recovery. With rates of capacity utilization on the increase, corporate profits moving up strongly, the stock and bond markets improving, and business confidence gaining, we can reasonably expect considerable strengthening this year of business plans for buying new equipment and building new facilities -- as normally happens in the course of a business cycle expansion.

The strength of recovery in business investment outlays this year, however, will depend to a large degree on the vigor of consumer markets. Businessmen across our land are still making plans for the future with great caution. While the recent improvement in consumer buying has been encouraging, the present more optimistic mood of consumers could be destroyed by a new burst of inflation. Any resurgence in the pace of inflation this year would pose a threat to consumer and business confidence, and thus to the further recovery of economic activity that is so urgently needed.

We as a Nation made notable progress last year in reducing the rate of inflation. The rise in consumer prices came down to 7 per cent, about half the rate recorded in 1974. The rise in wholesale prices slowed down even more. These improvements reflected slack demand in product markets and increased competitive pressures, but they were evidenced mainly in the first half of last year.

In fact, there has been some worsening in the rate of inflation since the middle of 1975. One troublesome sign has been the acceleration in wholesale prices of industrial commodities. During the second half of 1975, these prices increased on the average at an annual rate of almost 9 per cent, compared with 3-1/2 per cent in the first half. The advance of consumer prices quickened less rapidly -- from an annual rate of 6.6 per cent in the first half of 1975 to 7.5 per cent in the final six months. But the rate of inflation in consumer markets could worsen further, if recent sharp increases in wholesale prices are passed through to the retail level.

The trend of wage increases, while understandable, is also disturbing. Last year, wage rates rose on the average by 8 per cent -- far above the long-term rate of growth in productivity. This year, major collective bargaining agreements covering almost twice as many workers as in 1975 will need to be negotiated. If wage settlements in major industries exceed those of 1975 -- when wage and benefit increases for the first year already averaged around 11 per cent -- a new explosion of wages, costs, and prices may be touched off.

Some step-up in the rate of inflation was perhaps unavoidable during the latter half of last year, in view of the vigor of economic recovery. As the recovery proceeds, however, it is clearly the responsibility of government to manage economic policies so that a new wave of inflation, which would wreck our chances of lasting prosperity, is avoided.

Our country is now confronted with a serious dilemma in its search for ways to move the economy toward full employment. Conventional thinking about stabilization policies is proving inadequate. Stimulative financial policies have considerable merit when unemployment is extensive and the price level is stable or declining. But such policies do not work well if the price level keeps on rising while there is considerable slack in the economy. Recent experience both in our own and other industrial countries suggests that once inflation has become ingrained in the thinking of a Nation's businessmen and consumers, highly expansionist monetary and fiscal policies do not have their intended effect. In particular, instead of fostering larger consumer spending, they tend to lead to larger precautionary savings and sluggish consumer buying. The only sound fiscal and monetary policy today is a policy of prudence and moderation.

Over the course of the past year, the Federal Reserve has sought to foster a financial climate conducive to a satisfactory recovery, but at the same time to minimize the chances of rekindling inflationary pressures. Last spring, in our first report pursuant to House Concurrent Resolution 133, we announced the growth rates of the monetary and credit aggregates that would be sought over the next year in furthering those objectives.

A growth range of 5 to 7-1/2 per cent was adopted for M_1 -- that is, currency plus demand deposits held by the public. Higher growth ranges were specified for the broader monetary aggregates. For M_2, which also includes time and savings deposits other than large CD's at commercial banks, the growth range was initially set at 8-1/2 to 10-1/2 per cent, and subsequently widened by reducing the lower end of the band to 7-1/2 per cent. For a still broader monetary composite, M_3, which also includes deposits at thrift institutions, the range was initially set at 10 to 12 per cent, and then widened to 9 to 12 per cent.

At the time these ranges were established, concern was expressed by some economists, as well as by some members of Congress, that the rates of monetary growth we were seeking would prove inadequate to finance a good economic expansion. Interest rates would rise sharply, it was argued, as the demand for money rose with increased aggregate spending, and shortages of money and credit might soon choke off the recovery.

We at the Federal Reserve did not share this pessimistic view. We knew from a careful reading of history that the turnover of money balances tends to rise rapidly in the early stages of an economic upswing. Consequently, we resisted the advice of those who wanted to open the tap and let money flow out in greater abundance.

Subsequent events have borne out our judgment. Increases in the turnover of money balances have been even larger than we at the Federal Reserve had anticipated. Over the past two quarters, the velocity of M_1 -- that is, the ratio of GNP to M_1 -- increased at an annual rate of over 10 per cent, the largest increase for any half year in the past quarter century. Moreover, this rise in velocity was not associated with higher rates of interest or developing shortages of credit. On the contrary, conditions in financial markets continued to ease, and are more comfortable now than at any time in the past two years.

There is a striking contrast between the movement of interest rates during the current recovery and their behavior in past cyclical upswings. Short-term interest rates normally begin to move up at about the same time as the upturn in general business activity, although the extent of rise varies from one cycle to another. In the current economic upswing, a vigorous rebound of activity, a continuing high rate of inflation, and a record volume of Treasury borrowing might well have been expected to exert strong upward pressures on short-term interest rates. However, after some runup in the summer months of last year, short-term rates turned down again last fall, and have since then declined to the lowest level since late 1972. Long-term rates have also moved lower; yields on high-grade new issues of corporations are now at their lowest level since early 1974.

Conditions in financial markets thus remain favorable for economic expansion. Interest rates are generally lower than at the trough of the recession. Savings flows to thrift institutions are still very ample, and commitments of funds to the mortgage market are still increasing strongly. Mortgage interest rates are therefore edging down.

Moreover, the stock market has been staging a dramatic recovery. The average price of a share on the New York Stock Exchange at present is about 60 per cent above its 1974 low. A large measure of financial wealth has thus been restored to the millions of individuals across our land who have invested in common stocks. Besides this, the improvement in the stock market has made it considerably easier for many firms to raise equity funds for new investment programs or for restoring their capital cushions.

In general, the liquidity position of our Nation's financial institutions and business enterprises is now much improved. Corporations issued a record volume of long-term bonds last year, and used the proceeds to repay short-term debts and to acquire liquid assets. Commercial banks reduced their reliance on volatile funds and added a large quantity of Federal securities to their asset portfolios. The liquidity position of savings banks and savings and loan associations has likewise been strengthened.

The market for State and local governmental securities has, of course, been adversely affected by the New York City financial crisis. Even in this market, however, interest rates are now below their 1975 highs, and the volume of securities issued has remained relatively large. The difficulties of New York City, moreover, have had a constructive influence on the financial practices of State and local governments -- as well as on other economic units -- throughout the country. The emphasis on sound finance which is now under way, enhances the chances of achieving a lasting prosperity in our country.

These notable accomplishments in financial markets indicate, I believe, that the course of moderation in monetary policy pursued by the Federal Reserve last year has contributed to economic recovery. The Board was pleased to learn that the Senate Banking Committee, in its recent "Report on the Conduct of Monetary Policy," agrees with this view.

Since last spring, growth rates of the major monetary aggregates -- though varying widely from month to month -- have generally been within the ranges specified by the Federal Reserve. Thus, on a seasonally adjusted basis, the quarterly average level of M_1 rose over the past three quarters at an annual rate of 5.7 per cent; M_2 rose at a rate of 9 per cent, while M_3 rose at a rate of 12 per cent. The growth rate of M_1 was toward the lower end of the specified range, while growth in M_2 was near the midpoint of its range. Growth in M_3, on the other hand, was at the upper end of its range.

The growth rates that I have just cited reflect new seasonal adjustment factors, published a few weeks ago, that emerged from an intensive review by the Federal Reserve staff of the process of making seasonal adjustments in our monetary statistics. This review revealed some facts about the behavior of money supply data that I believe this Committee should have at its disposal.

Seasonal adjustment of the money stock, as with other economic time series, involves a rather large element of judgment. I have attached to this statement a table showing monthly, quarterly, and semi-annual changes in M_1 that would be obtained by applying a variety of plausible seasonal adjustment procedures. The results differ by a wide margin. For example, in November, the seasonally adjusted annual rate of change in M_1 may be estimated in a range running from 3 per cent to 13 per cent; for December, the range is from -7 per cent to +3 per cent. In view of such wide ranges, no one can say with any confidence what happened to the seasonally adjusted stock of money in those months.

These observations on seasonal measurement reinforce a judgment that I have frequently expressed, namely, that many financial observers attach a degree of importance to short-run movements of money balances that cannot be justified. In any event, it is doubtful whether small monthly changes in the stock of money balances have any real meaning for economic activity. The narrowly-defined money stock, M_1, totals at present nearly \$300 billion. Whether that stock increases in any one month to \$301 billion or to \$302 billion -- the difference between an annualized growth rate of 4 per cent and one of 8 per cent -- is unlikely to have a perceptible impact on the condition of the real economy.

Over longer periods, of course, such technical considerations as seasonal adjustment create fewer difficulties in interpreting movements of the various measures of money balances. But there are other problems of interpretation which must be recognized in evaluating monetary policy. We are living in a world of very rapid change in financial technology. New financial practices have been spreading through our markets for the past 20 or 30 years. Of late, moreover, the innovative process has accelerated, and it appears that the amount of money needed during the past year or two to finance a given dollar volume of GNP has been substantially smaller than would have been the case in earlier years.

Economists have sought for many years to measure the public's demand for money by relating this magnitude to the level of the gross national product, to interest rates, and to other measurable factors. These money demand relations play an important role in most econometric models of the economy. The Board's staff uses such a model as one tool, among others, in analyzing economic and financial developments. While the money demand equation in this model has fairly often yielded poor predictions for individual quarters, these errors did not tend to cumulate. In other words, predictions for a series of quarters tended to fluctuate around the actual level of the narrowly-defined money stock, rather than to diverge progressively from it.

Since the third quarter of 1974, however, this equation has persistently and increasingly overpredicted the amount of money demanded by the public to finance transactions. By the last quarter of 1975, the overprediction had cumulated to $19 billion -- about 6 per cent of the actual level of M_1. This means that if relationships that existed on the average over the postwar period had continued to hold, growth in M_1 at an annual rate of about 8-1/2 per cent would have been needed during the past six quarters to finance the observed rise in nominal GNP at the interest rates that actually prevailed. The actual growth rate of M_1 during those six quarters was only about half that large.

A number of factors are clearly responsible for the reduction in the amount of money needed to finance the rise in GNP, but their quantitative importance is difficult to ascertain. One important consideration is the rise of interest rates to unprecedented levels in 1974. The attractiveness of high yields on a variety of close substitutes for demand deposits led to the development of new techniques of cash management that have continued in usage since then. As a result, businesses and consumers are now keeping a larger fraction of their transactions and precautionary balances in interest-bearing liquid assets.

Moreover, as I have noted on previous occasions, numerous financial innovations and regulatory changes have facilitated the process of economizing on the sums held in the form of demand deposits. These developments have included the spread of overdraft facilities in banks, increased use by consumers of general-purpose credit cards, the growth of NOW accounts in New Hampshire and Massachusetts, the emergence of money-market mutual funds, the development of telephonic transfers of funds from savings to checking accounts, and the growing use of savings deposits to pay utility bills, mortgage payments, and other obligations.

One very recent development that has had a considerable impact on the behavior of M_1 was the regulation issued by the banking agencies last November, which enabled partnerships and corporations to open savings accounts at commercial banks in amounts up to $150,000. This regulatory action was of considerable benefit to small businesses. It also placed commercial banks on a more nearly comparable footing with savings and loan associations, which have long been able to issue such accounts without any limitation on size. A special survey conducted by the Federal Reserve indicates that by January 7 around $2 billion had already been moved into these new accounts at commercial banks. Since the bulk of these funds probably were held previously as demand balances, this shift of deposits has undoubtedly accounted for a significant part of the weakness of M_1 in late 1975 and early this year.

The relatively slow rate of growth in money balances during recent months has been watched carefully, and at times with considerable concern, by the Federal Reserve. In view of the rather rapid pace of economic expansion, the relative ease of financial markets, and the absence of any evidence of a developing shortage of money and credit, we have been inclined to view the recent sluggish rate of expansion in M_1 as reflecting the influence of various factors that are reducing the amount of narrowly-defined money needed to finance economic expansion. However, since we could not be entirely certain of our views, we have taken steps recently to ensure that the rate of monetary expansion does not slow too much or for too long.

During the past three months or so, open market policies have therefore been somewhat more accommodative in the provision of reserves to the banking system. This has been reflected in a decline of the Federal funds rate to around 4-3/4 per cent. Last month, the discount rate was lowered from 6 to 5-1/2 per cent. And on two occasions -- in mid-October and again in late December -- the Board reduced reserve requirements. These reductions were aimed principally at encouraging a further lengthening of the maturities of time deposits of member banks, but they also released nearly $700 million of reserves and thus enabled banks to support a higher level of money balances.

In taking these steps, our objective has been to stay on a course of monetary policy that will continue to support a good rate of growth in output and employment, while avoiding excesses that would aggravate inflation and create trouble for the future. We recognize, however, that recent developments with regard to economies in money use make it very difficult to ascertain how much growth in money and credit will be needed in 1976 to achieve our objectives. Substantial further economies of money use could well be realized this year; on the other hand, resumption of a more normal relationship between the growth of money balances and the growth of GNP is entirely possible.

In light of present conditions in the economy and in financial markets, the Federal Open Market Committee has projected growth ranges of the monetary aggregates for the year ending in the fourth quarter of 1976 that differ only a little from those announced previously. For M_2 and M_3, the projected growth ranges remain at 7-1/2 to 10-1/2 per cent, and 9 to 12 per cent, respectively. The growth range for M_1 has been widened somewhat, to a 4-1/2 to 7-1/2 per cent band. The lowering of the bottom end of the range takes into account, among other factors, the transfer of funds from demand balances to business savings accounts at commercial banks -- a development that lowers the growth rate of M_1, but leaves unaffected the growth rates of M_2 and M_3.

The profound uncertainties that at present surround monetary developments, particularly the behavior of M_1, require a posture of exceptional vigilance and flexibility by the Federal Reserve in the months ahead. We believe that the growth ranges we have specified will prove adequate to finance a good expansion of economic activity in 1976. In shaping monetary policy, we will probably need to give more weight under present circumstance to the behavior of broader monetary aggregates than to movements in M_1. And we must certainly remain alert to the possibility that our longer-run projected ranges may need to be altered in view of ongoing changes in the financial world.

As my colleagues and I have frequently emphasized, the objectives of the Federal Reserve are to assure enough money and credit to finance a good expansion of economic activity and at the same time protect the value of the dollar. If the attainment of these objectives should, in our judgment, require a change of the monetary growth ranges that I have today specified, this Committee can be sure that we shall not hesitate to do so.

Let me remind the Committee, in this connection, that the growth rates of money and credit presently desired by the Federal Reserve cannot 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 eventually be necessary to reduce the rate of monetary and credit expansion. The Federal Reserve does not believe the time for such a step has yet arrived. But in view of the strong economic recovery that has been under way since last spring, we must be on our guard.

In closing, let me state once again that our Nation cannot achieve the goal of full employment by pursuing fiscal and monetary policies that rekindle inflationary expectations. Under current conditions, the return to full employment is likely to depend heavily on policies that will serve to re-invigorate the forces of competition and release the great energies of our people. This is why structural reforms of our economy deserve more attention from members of Congress and students of public policy than they are as yet receiving.

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GROWTH RATES OF M_1 REFLECTING DIFFERENT SEASONAL ADJUSTMENT PROCEDURES
(Seasonally adjusted annual rates, in per cent)

	MOVING SEASONAL PROCEDURES						CONSTANT SEASONAL PROCEDURES		
	Multiplicative factors				Additive factors		Additive	Multiplicative factors	
		X-11 Options			Sum of components (1965-75)		Regression sum of components (1965-75)	Daily method Sum of components (1965-75)	X-11 Option 5 M_1 total (1965-75)
	Published Series 1/	M_1 total (1965-75) Option 0	M_1 total (1965-75) Option 4	Sum of components (1965-75)	X-11	Regression			
	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1975--January	-5.5	-2.1	-8.0	-2.1	-5.5	-4.7	-10.9	-8.9	-10.5
February	0.4	1.7	4.3	0.8	-3.0	3.0	-6.4	2.6	2.1
March	8.5	7.2	8.0	7.6	9.3	7.2	11.0	10.6	11.5
April	3.8	4.6	3.8	4.2	3.3	5.1	8.0	1.3	2.5
May	11.3	8.8	9.6	8.8	9.2	9.2	5.5	10.9	11.3
June	13.7	12.1	14.6	11.7	12.5	13.3	19.2	16.7	15.4
July	4.1	4.5	2.9	4.5	5.0	6.2	6.2	3.3	4.9
August	5.3	6.6	5.7	7.0	5.8	6.6	1.2	5.3	4.9
September	2.4	4.5	3.7	3.7	4.4	6.1	2.0	1.6	0.4
October	-0.4	-0.4	-1.2	0.4	0.4	-1.6	-1.6	-0.8	-3.3
November	9.4	6.1	7.7	5.7	7.3	3.2	13.1	11.4	11.4
December	-3.6	-4.9	-2.4	-2.8	-0.8	-6.9	2.8	-4.1	-1.2
Qtrly--I	1.1	2.3	1.4	2.1	0.3	1.8	-2.1	1.4	1.0
II	9.7	8.6	9.4	8.3	8.4	9.3	11.0	9.7	9.8
III	4.0	5.2	4.1	5.1	5.1	6.3	3.1	3.4	3.4
IV	1.8	0.3	1.4	1.1	2.9	-1.8	4.8	2.2	2.3
Qtrly Avg.--I	0.4	1.6	0.7	1.4	0.6	0.4	-0.8	--	0.3
II	7.3	6.6	7.3	6.5	6.3	7.2	7.8	7.5	7.9
III	7.2	7.1	6.9	7.1	8.6	8.3	7.3	7.4	7.5
IV	2.6	2.5	2.6	2.7	2.2	1.4	3.4	3.0	1.9
Half Year--I	5.4	5.4	5.4	5.2	4.4	5.6	4.4	5.6	5.4
II	2.9	2.8	2.7	3.1	4.0	2.3	4.0	2.8	2.9
Half Year Avg.--I	3.9	4.1	4.0	4.0	3.6	3.8	3.5	3.7	4.1
II	4.9	4.8	4.8	4.9	5.4	4.9	5.4	5.2	4.8

1/ The published series is derived by judgmental adjustments applied to the X_{11} multiplicative sum of components method of moving seasonals