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Statement by

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before the

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I am pleased to meet once again with the Joint Economic Committee to present the views of the Federal Reserve Board on the condition of the national economy.

A year ago, when I appeared at your hearings on the Economic Report of the President, our economy was already in the final stages of the most severe recession of the postwar period. Corrective forces -- some internal to the economy, others emanating from governmental policies -- were at work, and an upturn in business activity soon got under way.

Since last spring, we have experienced a substantial economic recovery. According to present indications, 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 last April, the combined output of factories, mines, and power plants has increased at an annual rate of 11-1/2 per cent. The advance was initially most prominent in the textile, leather, paper, and chemical industries; but the scope of the recovery broadened in the fall and winter months and now includes a wide range of durable as well as nondurable goods.

As production rose, the demand for labor strengthened. With last month's sizable gain, total employment across the Nation has risen over 2 million from its low point last March. This gain has been accompanied by a significant lengthening of the average workweek, particularly in manufacturing and mining. Meanwhile, the unemployment rate has come down from about 9 per cent to 7-3/4 per cent. The number of individuals out of work still remains deplorably high; but the new entrants or re-entrants into the labor force now account for a larger part of the unemployed total than six or nine months ago, while job losers account for a substantially smaller part.

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, and it is now well above that average figure in industries such as textiles where the recovery of production has been especially rapid.

As we look back, it is clear that the consumer led the way out of recession and into recovery. Early in 1975, when price concessions became fairly common, consumer purchases began to pick up. Consumer buying was further buttressed during the spring and summer months by tax rebates and supplementary social security checks.

Sustained demand for our exports also helped to pave the way for economic recovery. Of late, our foreign trade has increased substantially, and export markets nowadays absorb about an eighth of our total output of goods. The strong competitive position achieved by the United States in world markets during the past two or three years played an important role in cushioning the recent decline of our economy.

Thus, with sales to both foreigners and American consumers well maintained, business firms were able to make good progress last year in clearing their shelves of excess inventories. By early summer, stocks had come into reasonable balance with sales in most consumer lines, and many firms engaged in retail and wholesale trade therefore began to rebuild inventories. At the same time, the pace of inventory liquidation slowed considerably in the manufacturing sector. For all nonfarm businesses, liquidation

of inventories receded from an annual rate of about $30 billion in the second quarter to a rate of $6 billion in the third and fourth quarters of last year. This readjustment in business inventories has been a major factor in the recovery of our Nation's production of goods and services.

Last fall, the rate of advance in economic activity slowed for a very brief period. But the pace quickened toward year-end, and the economy entered 1976 on a strong upward trend. In December, industrial output rose almost one per cent and another increase of 0.7 per cent occurred last month -- with gains widely distributed among consumer goods, business equipment, and other major sectors. The market for jobs also extended its improvement. In fact, the number of manhours worked in private nonfarm industries increased at an annual rate of more than 8 per cent in December and January.

With employment and incomes rising swiftly, consumers began buying more liberally, as is evident from the recent surge in retail sales. In December, retail sales rose almost 3 per cent on a seasonally adjusted basis, and they have continued at a high level since then. Sales of domestic automobiles last month reached the highest level since August 1974.

This upsurge of consumer spending has resulted in further reduction of business inventories, so that the ratio of inventories to sales is now unusually low at most retail outlets, and also at manufacturing establishments producing nondurable goods. Businessmen are still reluctant to reorder in volume until they are more confident that recovery is taking hold. But with sales continuing to increase, they 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. Indeed, accumulation of needed inventories may act as a significant stimulus to recovery throughout most of this year.

Prospects for residential construction also have improved. Prices of new homes remain exceedingly high and this is bound to limit the recovery in homebuilding. Of late, however, builders have begun to place more emphasis on smaller -- or semifinished -- homes, and thereby have broadened their markets. The inventory of unsold units -- especially in the single-family sector -- has declined, and the vacancy rate for rental units fell sharply during the final quarter of last year. Furthermore, lenders

are amply supplied with funds and mortgage credit is now readily available. Over the course of 1976, housing starts are therefore likely to extend significantly the gains already made during 1975.

Exports, too, will probably register further improvement this year. Economic recovery is finally under way in Japan and other industrial countries, and as it gathers momentum the demand for our exports should intensify. However, the foreign trade balance is likely to narrow this year, because our own 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 expansion in the year ahead. Recent developments in this sector have been mixed. Production of business equipment has risen in each of the past three months -- as sales of farm implements, mining and oil field equipment, and some other kinds of industrial machinery have advanced. Investment in new structures by public utilities has also risen. Nevertheless, some indicators of business capital spending remain rather weak. New orders for nondefense capital goods have risen only modestly since last spring, and contract awards for

commercial and industrial buildings have yet to show any improvement.

Business fixed investment, however, often lags behind other major categories of demand during the early stages of a recovery. With rates of capacity utilization increasing, 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 precise magnitude of the recovery in business investment outlays 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.

Our 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. Some of this improvement stemmed from the absence of powerful special factors -- such as the quadrupling in prices of imported oil, short supplies of agricultural commodities, and the termination of wage and price controls, all of which drove up prices in 1974. However, the slowdown in the rate of price advance last year -- particularly during the first half -- also reflected slack demand in product markets and increased competitive pressures.

The progress made in 1975 on the price front still left us a long way from our national goal of general price stability. Moreover, some worsening seems to have taken place in recent months in the rate of inflation. Since the middle of 1975, wholesale prices of industrial commodities have increased on the average at an annual rate of over 8 per cent, compared with 3-1/2 per cent in the first half of last year. The advance of consumer prices has quickened only a little -- 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. Even so, the apparent reversal of the trend toward lower price increases is a troublesome sign.

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 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 is avoided.

Our country is now confronted with a serious dilemma. Over 7 million people are still unemployed. Many of them have been seeking work for an extended period; the average

duration of unemployment is nearly 17 weeks. The hardship created by unemployment has increased for those whose unemployment benefits have been exhausted. More jobs are clearly needed -- not only for workers who are now unemployed but also for those who will soon be entering the labor force.

In the current inflationary environment, the conventional tools of stabilization policy cannot be counted on to restore full employment. 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 may lead to larger precautionary savings and sluggish consumer buying. The only sound fiscal and monetary policy today is a policy of prudence and moderation.

One of the urgent tasks facing our Nation is to end the persistent Federal deficits that have been a major source of our inflationary problem. Since 1960, the Federal budget has been in deficit in every year but one. The cumulative deficit in the unified budget over the past ten years, including the official

estimate for the current fiscal year, comes to $217 billion. If the spending of off-budget agencies and government-sponsored enterprises is taken into account, the aggregate deficit for the ten years amounts to almost $300 billion.

This sorry record of deficit financing means, of course that we as a people have been unwilling to tax ourselves sufficiently to finance the recent sharp increases of governmental spending. In this bicentennial anniversary of our Nation's independence, we would do well to reflect on the fact that it took all of 186 years for the annual total of Federal expenditures to reach the $100 billion mark. This occurred in fiscal year 1962. Only nine years later, in fiscal 1971, expenditures already exceeded $200 billion. Four years from that date, in fiscal 1975, the $300 billion mark was passed. And unless expenditures are held under a very tight rein, Federal spending will easily exceed the $400 billion level in fiscal 1977.

The President's budgetary program for the coming fiscal year, taken on an over-all basis, would go far toward breaking the spiral of Federal spending which has been so largely responsible for the ten-year stretch of inflation that culminated in the deep recession from which we are now emerging. The proposed budget

would limit the rise of spending in fiscal 1977 to 5-1/2 per cent, compared with an average yearly increase of 12 per cent over the previous five years. The Federal deficit is projected to decline from $76 billion in the current fiscal year to $43 billion in the next, with a balanced budget finally in view by fiscal 1979.

Some well-meaning citizens are now urging the Congress to provide added fiscal stimulus in the interest of speeding the return to full employment. I would warn this Committee that still larger Federal expenditures and a bigger deficit may fail of their purpose. A deeper deficit would require the Treasury to rely more heavily on credit markets, thus drawing on funds badly needed for homebuilding and business capital formation. Worse still, a significantly larger deficit would revive fears of accelerating inflation, and weaken the confidence of businessmen and consumers that is essential to the restoration of general prosperity.

Moderation in monetary policy is also needed to bolster confidence in the economic future. That is why the Federal Reserve has been so diligently seeking to foster a financial climate conducive to a satisfactory recovery, but at the same time to minimize the chances of rekindling inflationary fires.

Since last spring, growth rates of the major monetary aggregates -- while varying widely from month to month -- have generally been within the ranges specified by the Federal Reserve in its periodic reports to the Banking Committees of the Congress. On a seasonally adjusted basis, the quarterly average level of M_1 -- that is, currency plus demand deposits held by the public - rose over the last three quarters of 1975 at an annual rate of 5.7 per cent. M_2, which also includes time and savings deposits at commercial banks other than large certificates of deposit, rose at a rate of 9 per cent. A still broader monetary composite, M_3, which also includes deposits at thrift institutions, rose at a rate of 12 per cent.

These increases in the monetary aggregates were accompanied, as we expected, by a sharp rise in the turnover of money balances. The rising velocity of money has not, however, been associated with higher rates of interest or developing shortages of credit -- as some critics of Federal Reserve policy had predicted. On the contrary, conditions in financial markets have 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 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 since then have declined to the lowest level since late 1972. Long-term rates have also moved down; 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 continuing to increase. 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 advance in stock prices 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 was, of course, adversely affected by the New York City financial crisis. Even in this market, however, interest rates are now well 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 that is now underway 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.

Last spring, when the Federal Reserve first announced its projected growth ranges for the monetary aggregates, 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, and our judgment has been borne out by experience. We knew that the turnover of money is apt to increase rapidly with a return of confidence. We knew also that financial technology

has been changing, that the innovative process has accelerated of late, and that significant economies in the handling of cash balances were therefore being effected.

The developments that have recently fostered economizing on the sums held as currency or demand deposits include the spread of overdraft facilities at banks, increased use of 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 downward influence on the level of demand deposits 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.

The relatively slow rate of growth in demand deposits during recent months has been watched carefully 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 M1

as reflecting the influence of various factors that are reducing the amount of narrowly-defined money needed to finance economic expansion. However, since it is impossible to project the scale on which further economies may be realized, we have taken steps 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 at 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.

As I indicated in testimony before the House Banking Committee earlier this month, 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.

We believe that the monetary growth ranges we have projected will prove adequate to finance a good expansion of economic activity in 1976. But the uncertainties that at present surround monetary developments, particularly the behavior of M_1, will require a posture of exceptional vigilance and flexibility by the Federal Reserve in the months ahead.

Before closing, I would remind this Committee that fiscal and monetary policies alone cannot be expected to achieve our economic goals in the current economic and financial environment. Structural policies can make a significant contribution to the restoration of full employment and also to correcting the long-run inflationary bias in our economy. In the time remaining, let me briefly sketch several lines of attack that seem promising.

First, governmental efforts are long overdue to encourage improvements in productivity through larger investment in modern plant and equipment. This objective would be promoted by overhauling the structure of Federal taxation, so as to increase

incentives for business capital spending and for equity investments in American enterprises.

Second, we should face up to the fact that environmental and safety regulations have in recent years run up costs and prices and have held up industrial construction across our land. Progress toward full employment and price stability would be hastened by stretching out the timetables for achieving our environmental and safety goals.

Third, a vigorous search should be made for ways to enhance price competition among our business enterprises. The Congress is to be commended for putting an end to the so-called fair-trade laws. It would be desirable to go further and reassess the entire body of laws directed against restraint of trade by business firms and to improve the enforcement of such laws. We also need to reassess the highly complex governmental regulations affecting transportation and the many other laws and practices that impede the competitive process.

Fourth, governmental policies that affect labor markets have to be reviewed. There are grounds for thinking that the Federal minimum wage law is pricing many teenagers out of the job market, that the Davis-Bacon Act is serving to escalate

construction costs, and that programs for income maintenance now provide benefits on such a generous scale that they may be blunting incentives to work. High unemployment and numerous job vacancies still exist side by side -- perhaps because job seekers are unaware of the opportunities, or because the skills of the unemployed are not suitable, or for other reasons. Surely, better results could be achieved with more effective job banks, more realistic training programs, and other labor market policies.

Finally, we need to think through the appropriate role of a limited incomes policy in the present environment. Recent experience has emphatically demonstrated that lasting benefits cannot be expected from comprehensive or mandatory wage and price controls. However, a policy that would permit modest delay in key wage or price increases, thus creating opportunity for quiet governmental intervention or for public hearings and the mobilization of public opinion, may yet be of significant benefit in reducing abuses of private economic power and moving our Nation towards the goal of full employment and a stable price level.

Under current conditions, the return to full employment will have to depend rather heavily on policies that serve to reinvigorate competition and release the great energies of our people. That is why structural aspects of our economy deserve more attention from members of Congress and other students of public policy than they are as yet receiving. In the Board's judgment, wise structural policies in conjunction with moderate fiscal and monetary policies offer the best hope for the attainment of a lasting prosperity.

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