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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 the Joint Economic Committee to present the views of the Board of Governors on the condition of our national economy.

The economic expansion now under way is entering its second year. Business activity began to pick up in the spring of 1975 and has gathered momentum since then. In the quarter now ending, the physical volume of total production will be about 7-1/2 per cent higher than a year ago.

As is typical of a period of cyclical expansion, the rebound of activity has been especially vigorous in the industrial sector. New data released this Monday by the Federal Reserve Board indicate that industrial production, that is, the output of our factories, mines, and power plants, has risen since March of last year at an annual rate of 13-1/2 per cent -- a stronger advance than was indicated by our earlier reports.

The expansion of economic activity in the various service trades as well as the industrial sector has led to material strengthening in the demand for labor. Total employment across the Nation has increased by more than 3-1/2 million from its low point in March 1975. This gain has been accompanied by significant lengthening of the average workweek -- especially in manufacturing, where the amount of overtime is back to the highest level since the summer of 1974. Meanwhile, long-term unemployment has sharply diminished, and the over-all unemployment rate has come down from about 9 per cent a year ago to 7-1/4 per cent presently.

The rate of utilization of our industrial plant has also moved up with the expansion of business activity. In the materials-producing industries, only about 70 per cent of available plant capacity was effectively used during the second quarter of 1975. At present, the rate of capacity use has reached 80 per cent in these industries. Where the recovery of production has been especially rapid, as in the paper industry and some branches of the textiles industry, the utilization of capacity already exceeds 90 per cent.

The intensity of the economic recovery to date has been close to the average for cyclical upswings of the period since World War II. Moreover, the pattern of the current expansion has been similar in many respects to that of its predecessors.

Consumers led the way out of recession last spring, and they have been a major source of stimulus to economic expansion since then. As confidence improved, they became more active buyers, and the rise in consumer spending outstripped by a considerable margin the increase in disposable income.

The advance of consumer buying, which began in markets for apparel and other nondurables, soon spread to durable goods. During the quarter now ending, consumers spent approximately 13 per cent of their after-tax incomes on durable goods -- compared with 11-1/2 per cent a year earlier. The automobile market has been especially active. In recent months, unit sales of domestic models have run about 50 per cent above their depressed level in April 1975.

As purchases of big ticket items rose, consumers incurred new indebtedness. However, the rate of increase in consumer instalment debt has thus far remained moderate in relation to consumer incomes.

The hesitation that developed recently in the pace of consumer spending is, in the Board's judgment, a transitory phenomenon. After a rapid advance from last December through this March, total retail sales remained unchanged in April and then declined somewhat in May. Temporary pauses of this kind are not uncommon during periods of cyclical expansion. Members of this Committee may remember that the lull in consumer buying last autumn was soon followed by a renewed surge of retail sales during the winter months. There is good reason to believe that the recent slowdown will also be temporary. The basic determinants of consumer spending are clearly favorable: real incomes of families are increasing, labor market conditions are improving, and so too is the liquidity position of consumers. I would therefore expect consumer spending to continue moving upward. In fact, incoming sales data for the past three or four weeks on automobiles and most other branches of retail trade suggest that a resumption of the upward trend is already under way.

A further rise of inventory investment should also add strength to general business activity. In many nondurable goods industries, inventories have now been restored to levels that are adequate to meet current rates of sales. In the durable goods trades, on the other hand, renewed accumulation of inventories is just getting under way. New orders for durable goods are now rising vigorously, and rebuilding of stocks should be a stimulus to production in the months ahead.

A larger, and more basic, source of stimulus to economic activity can be expected from increasing business outlays for new plants, machinery, and other equipment. Business capital spending typically joins the recovery process later than other sectors of the economy. But as utilization of capacity increases and profits improve during the course of an expansion, business firms typically move ahead more aggressively with their capital investment programs. Although such a development has been somewhat delayed in the present instance, the traditional pattern is again emerging.

Thus, production of business equipment has been rising since November 1975 at an annual rate of 11 per cent. Other indicators of business capital spending are also pointing strongly upward. New orders for nondefense capital goods have risen in each of the past five months, and in May were 16 per cent above their level at the end of 1975. Also, the most recent surveys of business anticipations indicate some further strengthening of plans for capital expenditures this year.

In the other major sector of private long-term investment -- that is, homebuilding -- the revival of activity has contributed to economic expansion since the spring of 1975. New housing starts last month were almost 50 per cent above their trough in early 1975, and unemployment among construction workers has fallen by a third from its cyclical peak.

The rebound in residential construction has been largely confined to single-family homes. Construction of apartment houses has been held down by several factors -- previous overbuilding, high construction costs, and lagging rents. In fact, inflated costs of construction, maintenance, and operation are now a major limiting factor for all branches of residential construction. It is reasonable, nevertheless, to anticipate a gradual further advance in homebuilding activity during the second half of this year. Residential building permits have been rising rather steadily and last month reached their highest level in two years. Mortgage credit is in ample supply in practically all parts of the country. Furthermore, while the construction of apartment houses has remained at a depressed level, vacancy rates for rental units have declined noticeably.

Our net trade balance with other countries may also show some improvement in the months ahead. During the past year of economic recovery, our foreign trade balance declined. The physical volume of imports -- which fell off sharply during the recession -- began to rise again during the third quarter of last year, reflecting the enlarged demand for petroleum, industrial supplies, and other goods needed to support the rise of industrial production or to meet consumer preferences. Our merchandise exports, however, have yet to regain the upward trend that was interrupted by world-wide recession.

Imports of industrial supplies and consumer goods will probably move up further as the expansion of our economy continues to cumulate. But the outlook for our export trades is also brightening. Although economic recovery in other industrial countries began later than in our own, the pace of economic expansion in Western Europe and Japan has of late begun to gather momentum. Material strengthening of demands for American machinery and other products is therefore to be expected.

During the course of the current expansion, several milestones have already been passed on the road to restoring our Nation's economic vitality. By early this year, the number of persons holding jobs had already regained the pre-recession level, and total employment has since then moved above the previous peak by nearly 1-1/2 million. The average level of real disposable income per person rose to an all-time high in the first quarter of 1976, and the real value of the gross national product now also exceeds the previous peak level reached in the final quarter of 1973.

Our country still has some distance to go, however, to regain full prosperity. It is therefore vital to maintain conditions that will foster continuation of a good rate of economic expansion.

Fortunately, the recovery process has thus far remained balanced and orderly. There have been few signs of the speculative excesses that sometimes develop in the course of a business-cycle expansion and inevitably cause trouble later on. Our Nation has made notable progress in reducing the rate of inflation. The rise in consumer prices came down from 12 per cent in 1974 to 7 per cent in 1975, and to an annual rate of 4 per cent in the first five months of this year. This recent further moderation in the rate of inflation, however, stems in large part from special factors that for a time reduced the prices of food and fuel. When these erratic items are excluded, it appears that the underlying annual rate of inflation has not diminished since mid-1975, and that it may still be about 6 or 7 per cent.

Any such rate of inflation constitutes a serious threat to the economy, and elimination of our disease of inflation must therefore remain a major objective of public policy. At the same time, it is important to recognize that we have managed during the past year to avoid a fresh outburst of inflation -- a development that would have quickly eroded the purchasing power of wages and savings, created strains in financial markets, undermined confidence, and sapped the strength of the forces of economic expansion.

Let me turn now to the role of monetary policy in these developments. The Federal Reserve was urged repeatedly during the past year to pursue a more expansionist policy in order to speed the return to full employment. 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 move up sharply, it was argued, as the demand for money and credit 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 experience, first, that the turnover of existing money balances is apt to increase rapidly with the return of confidence, second, that rapid expansion of money and credit is apt to intensify inflationary expectations and soon sow the seeds of another recession. Consequently, we resisted advice to open the tap and let money flow out in greater abundance.

The monetary policy pursued by the Federal Reserve fostered a moderate rate of monetary expansion. During the year ending this quarter, M_1, the narrowly-defined money stock, which includes only currency and demand deposits, grew about 5-1/4 per cent. A more broadly defined money stock, M_2, which includes also savings and time deposits other than large CD's at commercial banks, rose by 10 per cent.

These increases in the stock of money were sufficient to finance a large increase in the physical volume of output even at rising prices, because they were accompanied, as we expected, by a sharp rise in the turnover of money balances. Moreover, this rise in velocity was not associated with rising interest rates or developing shortages of credit. On the contrary, conditions in financial markets have remained relatively easy.

There is a striking contrast between the movement of interest rates during the current expansion 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. Upward pressures on short-term interest rates might well have been expected during the past year, in view of the vigorous rebound of economic activity, the continuing advance of the price level, and the record volume of Treasury borrowing. However, after some runup in the summer months of 1975, short-term rates turned down again last fall, and long-term rates also moved lower. By April of this year, interest rates on most short-term market securities had fallen to their lowest level since late 1972, while yields on high-grade new issues of corporations declined to their lowest level since early 1974. The main cause of the unusual behavior of interest rates during the past year was undoubtedly the lessening of inflationary fears, and the consequent reduction in the inflation premium that got built into interest rates -- particularly, the long-term rates.

The financial climate that has prevailed during the past year of economic recovery has permitted lenders and borrowers alike to strengthen their financial condition. For example, the liquidity position of savings banks and of savings and loan associations has improved markedly over the past year. Moreover, the flow of individual savings to the thrift institutions is still ample. Deposits at savings and loan associations -- the leading suppliers of home mortgage credit -- rose at an annual rate of

14 per cent in May, and the outstanding mortgage loan commitments of these institutions increased further -- to more than $20 billion, the highest level in three years.

Commercial banks have also rebuilt their liquidity. They have added a large quantity of short-term Treasury securities to their portfolios and they have also reduced reliance on volatile funds. The condition of the banking system has been further strengthened through widespread additions to retained earnings and some new issues of common stock. The ratio of capital to risk assets of commercial banks, which declined steadily during the early 1970's, has thus increased appreciably, and confidence in the banking system has been bolstered.

Our Nation's business enterprises have likewise taken advantage of the prevailing financial climate to improve their financial condition. Corporations issued a huge volume of long-term bonds during 1975, and they used much of the proceeds to repay short-term debt and to acquire liquid assets. This year, they are still finding long-term funds readily available. Public offerings of bonds by domestic corporations will total about $3 billion this month -- an extraordinary volume by historical standards. For a time, access to public markets for long-term funds was confined largely to firms with the highest credit ratings. Of late, however, some lower-rated firms have found a more receptive public market for their debt issues, as is reflected in a narrowing of the yield spread between Aaa- and A-rated bond issues from 1-1/2 percentage points last summer to about 1/2 percentage point this spring. Many medium-sized firms, and others with lower credit ratings, have met their needs for long-term funds through private placements with life insurance companies and other institutional lenders.

Besides this, an improved stock market has made it easier for corporations to raise equity funds for financing new investment programs or for restoring capital cushions. This month, corporate enterprises have sold about $1-1/2 billion of new shares to the public. If the pace of new stock offerings during the first half of this year is maintained over the next six months, the year will end with the largest volume of corporate stock flotations in our history.

These accomplishments in financial markets indicate, I believe, that the course of moderation in monetary policy pursued by the Federal Reserve over the past year has aided the process of economic recovery. Our actions during recent weeks have further served to reassure the business and financial community that we intend to stick to a course of monetary policy that will support further growth of output and employment, while avoiding excesses that would aggravate inflationary pressures and thus create trouble for the future.

As I indicated in testimony before the Senate Banking Committee, the Federal Open Market Committee recently reduced the upper limit of the projected growth range of M_1 in the year ahead from 7-1/2 per cent to 7 per cent, and the upper limit of M_2 from 10-1/2 per cent to 10 per cent. The changes are small, but they are a logical step in light of financial developments and the behavior of the economy.

The decision to reduce the upper limit of the ranges for M_1 and M_2 reflects the experience of the past year, when improvements in financial technology made it possible for a moderate rise in the money stock to finance a good economic recovery with declining interest rates. However, with a full year of renewed expansion in business activity already behind us, some downward adjustment in the upper boundary of the growth ranges for M_1 and M_2 might have been called for in any event. The adjustment in the projected growth ranges for

M_1 and M_2 over the year ahead was thus a very small but prudent step in the right direction. Looking to the longer future, it would be helpful if everyone recognized that the rate of monetary expansion we have recently projected is still too high to be consistent with general price stablity.

Another indication of our intention to adhere to a moderate course of monetary policy may be found in the prompt actions we took some weeks ago to ward off the threat of excessive growth of the monetary aggregates. In April, the pace of monetary expansion jumped very sharply -- to an annual rate of 15 per cent for M_1. We recognized that technical factors -- such as the decline in the Treasury's cash balance -- might be partly responsible, and that the bulge in the monetary growth rate might be temporary. We could not, however, risk an explosion of the monetary aggregates during a period of strongly advancing economic activity.

Over a period of several weeks, starting in late April, the Federal Reserve thus became somewhat less accommodative in meeting the demand for bank reserves. The upward movement in market rates of interest that followed reflected our actions as well as rising demands for credit. In more recent weeks, the pace of monetary expansion has again moderated; short-term interest rates have stabilized or fallen back, and long-term rates may have begun declining again.

In the Board's judgment, the small but prudent steps just described have bolstered confidence and enhanced prospects for sustaining a healthy economic recovery. The Board believes that the prospects for a durable prosperity would be further enhanced by moderation in the course of fiscal policy.

The deficit in the Federal budget has diminished very little over the past year -- especially when the operations of off-budget agencies and government-sponsored enterprises are taken into account, as they should be. During the first quarter of this year, the annual rate of deficit, as calculated in the national income and product accounts, was still close to $70 billion, and there is little evidence of a significant closing of the huge gap between receipts and expenditures during the second quarter. It is of the utmost importance that the Congress and the Administration cooperate to maintain tight control over Federal expenditures. At the present stage of the business cycle, a substantial decline of the Federal deficit is essential if renewed inflationary pressures are to be avoided and savings are to become available for much-needed private investment.

We can all take considerable satisfaction in the progress that has been made over the past year in restoring more prosperous conditions in our country. Both the Congress and the Administration deserve credit for improving the economic climate. Much remains to be accomplished, however. Unemployment remains much too high. Productivity has been lagging. The expansion of our industrial plant is proceeding at too slow a pace. The homebuilding industry and other branches of construction are still depressed. And the menace of inflation is still with us, though in a less virulent form than in many other countries around the world. Rampant inflation abroad -- West Germany and Switzerland are outstanding exceptions -- has contributed to the turbulence in foreign exchange markets this year.

Participants in the economic summit meeting just concluded in Puerto Rico have recognized the dilemma faced by economic policy makers throughout the advanced industrial world today. There is a pressing need for expansion in the economies of both the industrialized countries and the developing nations. However, traditional policies of economic stimulation may well prove counter-productive in today's environment of deeply-ingrained inflationary expectations.

The declaration of the Puerto Rico conferees regarding the need to maintain an economic climate that is conducive to enterprise and investment, while working towards the complete elimination of inflation, is both welcome and appropriate. Both in this country and abroad, our main hope for achieving lasting prosperity lies in adhering to prudent fiscal, monetary, and structural policies.

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