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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 House Banking Committee to present the report of the Federal Reserve Board on the condition of the national economy and the course of monetary policy.

The economic expansion now under way is well into its second year. By any reasonable yardstick, the Nation's economy has experienced a substantial recovery. In the quarter just ended, the physical volume of total production was 8-1/2 per cent above its trough in the first quarter of 1975. The rebound of activity in the industrial sector has been especially vigorous; the combined output of our factories, mines, and power plants has risen more than 16 per cent since March of last year.

The expansion of economic activity in the service trades as well as in the industrial sector has led to material strengthening in the demand for labor. Total employment across the Nation has risen about 3-1/2 million from its low in March 1975, and is now 1-1/4 million above the previous peak. The average length of the factory workweek has also risen, and the unemployment rate has declined from about 9 per cent to 7-1/2 per cent in the face of rapid growth of the labor force.

These gains in production and employment have been accompanied by larger personal incomes and rising consumer purchasing power. The average level of disposable income per capita has risen in real terms by 6-1/2 per cent since early 1975, and last quarter it was 1-1/2 per cent above its previous peak. Business profits, too, have rebounded as the workshops of the economy have returned to more efficient levels of operation.

In a typical business cycle, the rate of growth of economic activity slows after the first year of recovery. Thus, during the past five cyclical upswings, the physical volume of the Nation's total production rose, on average, by 8 per cent in the first year and 4 per cent in the second. This tendency for the pace of expansion to diminish during the second year often reflects a reduced stimulus from rebuilding of inventories.

In the current recovery, too, the rate of economic expansion has been influenced by the pace of inventory investment. Between the second quarter of last year and the first quarter of this year, the shift from extensive liquidation of inventories to moderate accumulation accounted for about 45 per cent of the increase in the physical volume of production. But in the quarter just ended, if preliminary estimates hold up, inventory investment no longer added to the growth of physical output.

In consequence, the real gross national product appears to have expanded at an annual rate of 4-1/2 per cent in the second quarter of this year, compared with 8 per cent over the preceding three quarters. Growth of industrial output also decelerated, particularly in industries producing nondurable goods. And while conditions in labor markets continued to improve in the second quarter, they did so to a lesser degree. Total employment, which increased 1.3 million during the first three months of this year, rose 800 thousand in the next three months. And the unemployment rate, which fell materially between December and March, has changed little over the ensuing months.

The recent slowdown in the rate of economic expansion has resulted not only from inventory adjustments; a pause in consumer spending also played a part in this development. After a rapid advance from last December through this March, retail sales grew slowly in April and then declined in May. Temporary pauses of this kind are not uncommon during periods of cyclical expansion. Indeed, recent sales figures suggest that a resumption of the upward trend is already under way. Retail sales rose nearly 3 per cent in June, and there were encouraging gains across the range of nondurable goods -- where sales had lagged in April and May.

We may reasonably expect further good gains in retail trade in the months ahead. 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. Furthermore, as optimism continues to spread, consumer expenditures will tend to rise more rapidly than the disposable income of consumers. As the recovery proceeds, consumer buying will in all likelihood remain a major source of strength in the economy.

A larger and more basic source of stimulus to economic activity can be expected from 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, business firms typically move ahead more aggressively with their capital expenditure 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 briskly since late last year. Other indicators of business capital spending are also pointing upward. New orders for nondefense capital goods have risen in each of the past six months, and in June were 18 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.

A rising level of outlays for plant and equipment creates a need for larger inventories of materials, component parts, and other supplies in the durable goods trades. Thus, while inventories in some nondurable goods industries have been restored to levels that are adequate to meet current rates of sales, renewed accumulation of inventories in the durable goods sector is just beginning. Total new orders received by producers of durable goods are now rising sharply, and rebuilding of their stocks should be a stimulus to production in the months ahead.

A revival of homebuilding activity has been contributing to general economic expansion since the spring of 1975. New housing starts rose 4 per cent further last month, as the number of single-family housing starts advanced to the level of three years ago.

Weakness in the multi-family sector, however, has limited the over-all improvement of residential building activity. Construction of apartment houses has been held down by previous overbuilding, lagging rents, and high construction costs. In fact, inflated costs -- of construction, maintenance, and operation -- have become a significant limiting factor for all branches of residential construction. Nevertheless, some signs of improvement have recently emerged even in the multi-family sector; in particular, vacancy rates for rental units have declined to the lowest level since 1972. With mortgage credit in ample supply in practically all parts of the country, a gradual further advance in homebuilding activity is likely in the months immediately ahead.

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

Activity in all major sectors of the private economy thus seems poised for further advances. Fortunately, the recovery process has thus far been well balanced, and the state of confidence has been steadily gaining. There have been few signs of the speculative excesses that often develop in the course of a business-cycle expansion. Consumer attitudes toward buying durable goods and homes have of late further improved, and conditions in financial markets remain favorable for continuance of economic expansion.

Developments in the money and capital markets during the current recovery contrast sharply with those observed in past cyclical upswings. Short-term interest rates usually begin to rise at about the time when general business activity turns up. Soon thereafter, inflows of savings to thrift institutions often begin to dry up, and the homebuilding industry is then adversely affected.

In view of the vigorous rebound of economic activity, the continuing advance of the price level, and the record volume of Treasury borrowing, strong upward pressures on short-term interest rates might well have been expected during the past year.

However, after some run-up in the summer months of 1975, short-term rates turned down again last fall, and long-term rates also moved lower. The main cause of the unusual behavior of interest rates was undoubtedly the lessening of inflationary fears over the past year, 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 economic recovery has permitted lenders and borrowers alike to strengthen their financial condition. The liquidity position of savings banks and of savings and loan associations, for example, has improved markedly over the past year or so. The flow of savings to these institutions has been abundant, and they have increased substantially their mortgage lending as well as added to their liquidity. The outstanding mortgage loan commitments of savings and loan associations -- the leading suppliers of home mortgage credit -- are now close to the highest dollar figure on record.

Commercial banks have also rebuilt their liquidity. They have done so by adding large amounts of short-term Treasury securities to their portfolios, besides reducing their 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 totaled $3 billion last 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. During the past several months, 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 at present. Many medium-sized firms, and others with lower credit ratings, have met their need for long-term funds through private placements with life insurance companies and other institutional lenders.

Besides this, an improved stock market has made it much easier for corporations to raise equity funds for financing new investment programs or for restoring capital cushions. During June, corporate enterprises 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 remainder of the year, 1976 will see the largest dollar 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 over the past year has aided the process of recovery in economic activity.

We at the Federal Reserve remain deeply concerned about the level of unemployment that still exists in our country. We recognize the pressing need for the Nation to regain more prosperous economic conditions. We also recognize, as thoughtful Americans generally do, that lasting prosperity will not be achieved until our country solves its chronic problem of inflation.

The inflation that is still damaging our economy and troubling our people began over a decade ago -- largely as a consequence of loose fiscal policies. Over the past ten years, the Federal budget has been in deficit in every fiscal year but one. Over that ten-year span, the total deficit in the Federal budget -- including off-budget agencies and Government-sponsored enterprises -- has cumulated to almost $300 billion. These huge and persistent deficits added little to our capacity to produce, but they added enormously to aggregate demand for goods and services. They have thus been directly responsible for a substantial part of the inflation problem. In financing these deficits, and also in meeting the large demands for credit by business and consumers, tremendous pressures were placed on our credit mechanisms, and the supply of money has tended to grow at a rate inconsistent with price stability.

In the early 1970's, the underlying inflationary trend caused by lax financial policies was greatly aggravated by a variety of special factors. In 1972 and 1973, crop harvests were poor both here and abroad, and a boom in economic activity developed throughout the industrialized world. Upward pressures on our prices were further augmented by devaluation of the dollar in international exchange markets, and by an enormous run-up in prices of gasoline, fuel oil, and other energy items. By 1974, these special factors combined with the underlying inflationary trend to set off an explosion of the general price level.

Our Nation has made notable progress since then 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. Over the first four months of this year, the rise in consumer prices moderated further, to a 3-1/2 per cent annual rate, reflecting a temporary decline in the prices of food and fuel. In the past two months, however, retail prices of food and fuel have again been increasing, and the annual rate of increase in consumer prices has stepped up to 6-1/2 per cent. Thus, it appears that the underlying 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. Monetary policy -- no matter how well designed and implemented -- cannot do the job alone. Adherence to a moderate course of monetary policy can, however, make a significant contribution to the fight against inflation.

A year ago, I reported to this Committee the Federal Reserve's projection that M_1 -- that is, the money stock defined so as to include only currency and demand deposits -- should grow between 5 and 7-1/2 per cent during the year ending in the second quarter of 1976. For M_2 -- which also includes consumer-type time and savings deposits at commercial banks -- a range of 8-1/2 to 10-1/2 per cent was deemed appropriate. For M_3 -- a still broader measure of money balances encompassing, besides the components of M_2, the deposits at nonbank thrift institutions -- the range was set at 10 to 12 per cent. As I informed the Committee at the time, we believed that these projected rates of growth of the major monetary aggregates would facilitate substantial recovery in economic activity without aggravating the problem of inflation.

Looking back, we find that the pace of monetary expansion was generally in line with the specified ranges. During the year ended in the second quarter of 1976, M_1 grew by 5.2 per cent, or near the lower end of the projected range. M_2, on the other hand, rose by 9.8 per cent, which was near the midpoint of its range, while M_3 grew 12.1 per cent, or close to the top end of its range.

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. Some economists as well as some members of Congress expressed concern that the rates of monetary growth we were seeking would prove inadequate to finance a good economic expansion. We at the Federal Reserve respected but did not share this pessimistic view. We judged from experience, first, that the turnover of existing money balances is apt to increase rapidly with the return of confidence, second, that more rapid expansion of money and credit is likely 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 moderate rate of monetary expansion fostered by the Federal Reserve proved quite sufficient to finance a large increase in the physical volume of output and a still larger increase in the dollar volume of output. As expected, the increase of money stocks was accompanied by a sharp rise in the turnover of money balances. Moreover, neither rising interest rates nor developing shortages of credit were associated with this rise in velocity. On the contrary, conditions in financial markets, as I noted earlier, have been relatively easy, and they remain favorable to economic expansion.

Over the course of the past year, the Federal Reserve made several modifications in its projected growth ranges. Last October, the lower boundary of the range for both M_2 and M_3 was reduced by one percentage point. This January, the lower boundary of the range for M_1 was reduced by a half percentage point, and in April the upper limit for both M_1 and M_2 was lowered by a half percentage point.

These were small changes, but they were logical steps in light of economic and financial developments. Reductions in our projected growth ranges were needed because improvements in financial technology made it possible for a moderate increase in money balances to finance a good economic recovery with declining interest rates. But in any event, some reduction in the projected growth ranges would have been called for as the expansion in economic activity proceeded.

The downward adjustments of these growth ranges served to reassure the business and financial community that we intend to stick to a course of moderation in monetary policy. Another indication of our firm resolve was the prompt action taken some weeks ago to ward off a threat of excessive growth of the monetary aggregates. In April, M_1 expanded very sharply--to an annual growth rate of 15 per cent. We recognized that technical factors--such as the decline in the Treasury's cash balance--were 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 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. Subsequently the pace of monetary expansion moderated, and interest rates have declined again.

This temporary rise of interest rates was largely confined to sensitive market yields. Interest rates on loans to small businesses and farmers, also on instalment loans to consumers, have continued to move down or remain substantially unchanged.

Most interest rates at the present time are at or below their levels in the spring of 1975, when the economic recovery began. For example, the yield on 3-month Treasury bills reached a low of around 5-1/4 per cent in May 1975, and is now at about that same level. The rate on new issues of high grade corporate bonds in May 1975 was 9-1/2 per cent; now, that rate is down to around 8-1/2 per cent. Interest charges on automobile instalment loans are at their lowest level since mid-1974, while those on bank loans to small businesses are lower than at any time in three years.

At its meeting last week, the Federal Open Market Committee specified growth ranges of the monetary aggregates for the year ending in the second quarter of 1977. The ranges differ only a little from those announced last May. The range of 4-1/2 to 7 per cent was retained for M_1. For M_2 the upper boundary of the range was reduced by a half percentage point; for M_3 the upper boundary was brought down by a full percentage point. Consequently, the new range is 7-1/2 to 9-1/2 per cent for M_2, and 9 to 11 per cent for M_3.

The projected range for M_1 was left unchanged because of considerable uncertainty about the transactions balances that may be needed over the next year to finance a good rate of economic expansion. During the first year of the economic recovery, the income velocity of M_1 rose by 8 per cent. Recently, however, the rise of velocity has slowed appreciably, and it would be reasonable to expect the financing of economic activity over the next year to depend less on increasing velocity of money balances than it did during the past year.

I have advised the Congress repeatedly that the rate of expansion in M_1 will have to be lowered gradually in order to be consistent with restoration of general price stability. However, in view of recent developments with regard to the turnover of M_1, a reduction of the previously projected growth of M_1 seems inappropriate at this time.

Some lowering of the growth ranges for M_2 and M_3 is nevertheless desirable. Depository institutions have experienced very ample inflows of savings over the past year, and some of them -- particularly among the thrift institutions -- have recently reduced somewhat the rates they pay on various classes of deposits or have taken other actions to discourage inflows of funds in excess of what they can lend or invest profitably. Since market interest rates on short-term securities have also risen marginally since April of this year, savings inflows of late appear to have moderated. Consequently, if the ranges of expansion in M_2 and M_3 are to be consistent with our projected range for M_1, they need to be lowered somewhat. These downward adjustments, I should add, are another small and prudent step in moving towards a rate of monetary expansion that may in time accommodate general price stability.

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 residential building 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 been a major factor in the turbulence of foreign exchange markets this year.

In conclusion, let me sketch briefly the directions in which our Nation may need to move in order to deal effectively with some of these problems.

First, the Board believes that the prospects for a durable prosperity would be 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. 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 desirable in order that savings may become sufficiently available for much-needed private investment and renewed inflationary pressures be avoided.

Second, we would be well advised to avoid actions that might damage public confidence or threaten the vitality of particular industries. For example, the recent ruling by the Federal Trade Commission on the "holder-in-due course" doctrine seems to have come at an unpropitious moment. It may well be reducing somewhat the availability of credit to consumers and some retailers at the very time when a continued strong rise of consumer spending is needed to foster further gains in production and employment. Also, serious discussion of legislation to split up the Nation's large oil companies may even now be discouraging the investment required to relieve our Nation's critical energy problem.

Third, we ought to move forward with structural changes that will enhance the prospects for returning to full employment without releasing a new wave of inflation. 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. There is a clear need in our country for a larger volume of business capital investment, and for greater reliance by business firms on equity funds in financing their capital expenditures. These objectives could be promoted by an overhaul of the structure of Federal taxation.

Governmental practices and programs affecting labor markets also have to be reviewed in any serious search for lasting measures to reduce unemployment. For example, the Federal minimum wage law is still pricing many teenagers out of the job market, and our present programs for unemployment compensation may be providing benefits on such a generous scale as to blunt incentives to work. We would also benefit from more effective job banks, more realistic training programs, and other labor market policies.

Structural changes in other areas are also needed 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 the nature and enforcement of our laws directed against restraint of trade by business firms; also the various restrictions on entry into the professions, the wage and employment standards in the Davis-Bacon Act, the proper role of trade unions in the public sector, the monopoly of first-class mail by the Postal Service, and the mass of governmental regulations that impede the competitive process and run up costs for business enterprises.

There are numerous structural measures besides those I have mentioned that might aid in the restoration of general prosperity.

Progress in this field is, I believe, a matter of urgency. Our Nation has tolerated high rates of unemployment and of inflation much too long. But our Nation cannot reach the goal of full employment by pursuing fiscal and monetary policies that rekindle inflation. The Board therefore urges the Congress and the Administration to move ahead on structural policies that promise to strengthen competitive forces in our markets and to open new opportunities for expansion of production and employment.

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