The attached statement by Arthur F. Burns, Chairman of the Board of Governors of the Federal Reserve System, was submitted to the Senate Budget Committee in response to a Committee request for a report on the condition of the national economy and the course of monetary and fiscal policy.

August 23, 1976

Statement by Chairman Arthur F. Burns
to the Senate Budget Committee

I am pleased to report to the Senate Budget Committee on the condition of the national economy and the course of monetary and fiscal 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 second quarter of this year, the physical volume of total production was 8-1/2 per cent above its trough in the first quarter of 1975. Moreover, the combined output of our factories, mines, and power plants has risen about 17 per cent since March of last year.

Widespread expansion of economic activities has led to material strengthening in the demand for labor. Total employment across the Nation has risen almost 4 million from its low in March 1975, and is now 1-1/2 million above the previous peak. The average length of the factory workweek has also risen, and the unemployment rate -- though still deplorably high -- is appreciably lower than in the spring of last year.

The 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 returned to more efficient levels of operation.

During the course of the recovery, 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 second quarter of this year, inventory investment no longer added significantly to the growth of physical output.

This is the main reason for the recent slowdown in the rate of economic expansion. In real terms, the gross national product rose at an annual rate of 4-1/4 per cent in the second quarter, compared with 8 per cent over the preceding three quarters. The lower rate in the second quarter reflects, besides inventory adjustments, the recent pause in consumer spending. After a rapid advance from last December through this March, the trend of retail sales flattened out. Temporary pauses of this kind are not uncommon during periods of cyclical expansion.

We may reasonably expect significant gains in retail trade to resume relatively soon. The basic determinants of consumer spending are clearly favorable: the number of persons at work is continuing to rise, real incomes of families are increasing, and the liquidity position of consumers is improving. Furthermore, as optimism continues to spread, consumer expenditures should tend to grow more rapidly than the disposable income of consumers. In all likelihood, as the recovery proceeds, consumer buying will remain a major source of strength in the economy.

Another and more basic source of stimulus to economic activity over the next year or two 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 boldly with their capital expenditure programs. Although such a development has been somewhat delayed in the present instance, the traditional pattern is again emerging.

Thus, major indicators of business capital spending are pointing upward. Production of business equipment has increased steadily since late last year. New orders for nondefense capital goods rose strongly in July, the seventh consecutive monthly increase. Contract awards for commercial and industrial construction are now moving up again. Also, recent surveys indicate some further strengthening of business plans for capital expenditures.

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 have been rising strongly, and rebuilding of their stocks should be a stimulus to production for some time.

A revival of homebuilding activity has been contributing to general economic expansion since the spring of 1975. New housing starts declined somewhat last month, but permits issued for new residential buildings -- a less volatile indicator -- advanced to the highest level in more than two years.

With mortgage credit in ample supply in practically all parts of the country, and with sales of new and existing houses once again rising, a gradual further advance in homebuilding activity appears to be in prospect. To be sure, weakness in the multi-family sector has been limiting 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. However, the problems of the multi-family sector are gradually being resolved -- in particular, vacancy rates for rental units are appreciably lower now than they were a year ago.

Our trade balance with other countries may also show some improvement as the recovery proceeds. 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 been gathering 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. 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. Conditions in the nonfinancial sector of the economy thus remain favorable for continued growth well into the future.

Conditions in the financial markets are also conducive to continuance of economic expansion. Interest rates usually begin to rise at about the time when general business activity turns up. In the present instance, however, most interest rates 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 for the year of around 5-1/4 per cent in May 1975, and is now about 10 basis points lower. 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.

The main cause of the unusual behavior of interest rates during this recovery has undoubtedly been 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 recovery has permitted lenders and borrowers alike to strengthen their financial condition. The liquidity position of savings banks and savings and loan associations, for example, has improved markedly. Moreover, the flow of savings to these institutions has remained abundant, and they have continued to increase their mortgage lending. 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, and the condition of the banking system has been further strengthened through widespread additions to retained earnings and some new issues of common stock.

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. During recent months, many lower-rated firms have found a more receptive public market for their debt issues, and others 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.

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 high 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 over $280 billion. These huge and persistent deficits have been directly responsible for a substantial part of the inflation problem.

In the early 1970's, the underlying inflationary trend caused by lax financial policies was greatly aggravated by a variety of special factors -- poor crop harvests here and abroad in 1972 and 1973, a world-wide boom in economic activity, devaluation of the dollar in international exchange markets, and 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 increase of 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 three months, however, retail prices of food and fuel have again been increasing, and the annual rate of advance 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.

As I indicated in recent testimony before the House Banking and Currency Committee, the objective of monetary policy now is to support further growth of output and employment, while avoiding excesses that would aggravate our underlying problem of inflation and create trouble for the future.

At its meeting in July, the Federal Open Market Committee projected 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. For M_1, the narrowly-defined money stock, which includes only currency and demand deposits, the range of 4-1/2 to 7 per cent was retained. For M_2, which includes also savings and consumer-type time deposits at commercial banks, the upper boundary of the range was reduced by a half percentage point. For M_3, a still broader measure of money balances that includes also the deposits of thrift institutions, 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. These small downward adjustments in the projected growth ranges for M_2 and M_3 were needed to achieve consistency with the projected ranges for M_1.

I have advised the Congress repeatedly that the rate of monetary expansion in our country will have to be lowered gradually in order to be consistent with restoration of general price stability. The Federal Reserve has taken some small, but prudent, steps in that direction over the course of this past year. Thus, our present longer-run projected ranges for the principal monetary aggregates are all somewhat lower than a year ago. Further steps to moderate the pace of monetary and credit expansion will be required as the economy returns to higher levels of resource utilization.

Let me assure this Committee that the Federal Reserve is firmly committed to a course of monetary policy that will accommodate an eventual return to general price stability. That is, I believe, the principal contribution that we at the Federal Reserve can make to the restoration of a lasting prosperity.

Monetary policy -- no matter how well designed and implemented -- cannot alone restore price stability and prosperous economic conditions in our country. Moderation in the course of fiscal policy is also needed. The deficit in the Federal budget is much too high -- 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, so that savings may become sufficiently available for much-needed private investment and renewed inflationary pressures be avoided.

This Committee has played a highly constructive role over the past year in alerting members of the Congress, and also the general public, to the urgent need for better control over Federal expenditures. The essential task of this Committee now, I believe, is to persuade the Congress to proceed very prudently with tax reductions and to hold expenditures for fiscal 1977 below the levels specified in the First Concurrent Resolution. Moreover, this Committee and the Congress should be actively seeking ways to restore a balanced budget in the near future.

Prudent monetary and fiscal policies are essential at this time in order to avoid a rekindling of inflationary fires as our economy returns to higher levels of production and employment. Our Nation would benefit, however, if the traditional tools of economic management were supplemented by structural policies designed to enhance the prospects for returning to full employment without releasing a new wave of inflation.

There is a clear need in our country for a larger volume of business capital investment. An overhaul of the structure of Federal taxation could promote this objective, and thereby hasten improvements in productivity.

Governmental practices and programs affecting labor markets 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 program 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 and more realistic training programs.

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. We therefore need to move ahead promptly 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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