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Statement by

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I am pleased to meet once again with this distinguished Committee to present the report of the Federal Reserve Board on the condition of the national economy and the course of monetary policy.

During the first year of recovery from the severe recession of 1974-75, the pace of economic growth was rapid. The physical volume of total production rose by 7-1/2 per cent. The level of industrial production -- that is, the output of our factories, mines, and power plants -- increased by 12 per cent. Employment across the Nation rose by 2 million, and the unemployment rate fell by more than a percentage point -- to 7-1/2 per cent.

A substantial part of the gain in the gross national product during the first year of recovery was attributable to inventory investment -- that is, a turnaround from extensive liquidation of inventories to a moderate rate of accumulation. The remaining and basic part of our gross national product -- that is, the purchase of goods and services by the consuming public, by our governmental units, by foreigners, and by business firms apart from their inventory adjustments -- grew 4-1/2 per cent in physical terms during the first year.

These final sales have continued to advance during the past two quarters about as rapidly as in the initial year of recovery. But inventory investment did not add to the growth of physical output after the first quarter of this year.

In the absence of further stimulus from inventory accumulation, the growth of over-all economic activity has moderated. The gross national product during the past two quarters rose at an average annual rate of 4-1/4 per cent, and industrial production advanced at a 6-1/2 per cent rate. Employment continued to move up by 1-1/2 million; but there was also a large increase in the labor force, and the unemployment rate drifted higher over the summer months.

Indeed, the growth of the civilian labor force has been exceptionally large during the past year, amounting to over 2 million persons. Some pickup in the rate of growth in the labor force is fairly common during a cyclical recovery because improving employment opportunities tend to attract men and women into the job market. In the present instance, however, the persistent pressure on family budgets caused by inflation has accelerated the rise in labor force participation and has thus slowed the reduction of unemployment. At a time of

inflation, the cost of living increases for everyone; the like, however, is not true of incomes. Many individuals are earning no more today than they did six months or a year ago, and some are earning less. As a consequence, more and more households have found it necessary for additional family members to work outside the home in order to make ends meet. This has been reflected in a sharp rise during the past year in the proportion of adult women and teenagers who are working or looking for work.

The slowdown in the rate of economic expansion since last spring has been widely noted, but it is useful to keep in mind that a roughly parallel development occurred in earlier postwar recoveries. During the previous 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. In those earlier postwar expansions, as in the present one, the diminished pace of expansion during the second year reflected a reduced stimulus from rebuilding of inventories.

Although the broad outlines of the current expansion thus resemble earlier recoveries, there has been a notable difference in the behavior of the capital goods sector. Expressed in constant

dollars, business outlays for new plants, machinery, and other equipment typically begin to move up at about the same time or soon after the upturn in general business activity. Throughout last year, however, these outlays either continued to decline or failed to rise. Since then, a moderate rate of advance has resumed. Nevertheless, business fixed investment in the third quarter of this year was only 2-1/4 per cent above its physical level in the first three months of 1975, when general business activity reached its trough. At the comparable stage of previous postwar upswings, business fixed investment had risen, on average, by about 15 per cent.

The sluggish advance of business capital spending in this recovery is a consequence in large part of the impact of the recession of 1974-75 on the psychology of the business community. Not many of the current generation of business managers had ever before experienced an economic decline of comparable severity. In recent times, the view has spread in business circles, as it already had in the academic community, that the old-fashioned business cycle was dead -- that any recession that might occur would prove to be brief and mild, since governmental policies could be relied upon to keep the economy moving forward at a rather steady pace. Businessmen were certainly unprepared for the slump in sales and production in 1974 and early

1975 that resulted from an inflationary process that got out of control and undermined the strength of the economy. In the aftermath of this hard experience, it should not be surprising that the rebuilding of confidence needed for a new surge of investment activity has proceeded rather slowly.

A gradual restoration of confidence, such as we have been experiencing, is also underway in other industrial countries. The inflation that played havoc with our economy was world-wide in scope, and so was the subsequent recession. Businessmen around the world are tending to be cautious in making major long-term investment commitments. Recovery has been slow or only moderate in Germany, France, Japan, and other industrial nations. Weakness in business capital outlays has been rather widespread, and most industrial countries have experienced a pause in economic expansion similar to our own.

The key to releasing the productive energies of our people, as well as the people of other industrial nations, lies in a further rebuilding of confidence -- that is, renewed hope of businessmen, investors, and consumers in their own and their nation's economic future. That process, I believe, is generally continuing. True, some recent surveys in our country

suggest that consumers have of late become somewhat more cautious. Yet, they are still adding to their purchases of goods and services. The personal savings rate fell last quarter to 6-1/2 per cent -- the lowest level in several years. Rising disposable income and the strengthened liquidity position of American families should, I believe, provide the basis for advances in consumer spending over the remainder of this year and on into 1977.

In the business sector, too, there are indications of a growing willingness to make commitments for the future. New orders for nondefense capital goods increased in seven of the first eight months of this year; they again increased, by 3 per cent, in September and are now about 20 per cent above their level last December. In recent months, the volume of contracts awarded for commercial and industrial construction has been running well above the average level in the early months of this year. The formation of new businesses has continued to grow. Moreover, the latest McGraw-Hill survey of investment intentions indicates that businesses plan to increase expenditures on plant and equipment by 13 per cent next year.

Historically, such surveys have tended to underestimate capital expenditures when economic activity was expanding. Both corporate profits and the utilization of industrial capacity have improved this year. Under such conditions, business firms are apt to move ahead energetically with their capital expenditure programs. Although such a development has been delayed in the present expansion, the traditional pattern now seems to be emerging, so that business capital outlays should be an important stimulus to economic activity next year.

Housing activity has been moving up at a good pace in recent months, and this should also help to strengthen the rate of economic expansion. Some slowdown appears to have occurred recently in the rising price of new homes. This is an encouraging development in a sector where rising costs have squeezed out many potential buyers. Residential building permits have advanced rather rapidly of late, and are now at the highest level in three years. New housing starts are moving up for both single-family and multi-family units. Sales of new homes are increasing. With mortgage credit in ample supply in practically all parts of the country, a continued advance in homebuilding activity may reasonably be expected.

Activity in the major sectors of the private economy thus seems poised for further advances. The recovery has proceeded in an orderly fashion, and there have been few signs of the speculative excesses that often develop in the course of a business-cycle expansion. The basic sources of strength underlying the expansion of economic activity do not appear to have been weakened by the recent pause in the pace of expansion. Final sales are still increasing and should continue to register good gains in the months ahead. Some imbalances in inventories that were a problem earlier this year -- particularly in the nondurable goods industries -- are being corrected. The depressing effect of strikes in the rubber and auto industries on industrial production, employment, and personal income is now behind us, and the recent steep decline of farm income may also be nearing an end.

Furthermore, foreign demand for our exports should increase as business activity expands further in Western Europe and Japan. Although our imports will also generally move up in response to our own economic expansion, the beginning of oil flows through the Alaskan pipeline should moderate the rise in oil imports in 1977.

All in all, it seems entirely reasonable to expect a pickup in the tempo of economic activity in the near future. Certainly, conditions in financial markets remain conducive to continued economic expansion.

The Federal Reserve has pursued a moderate monetary policy during the course of this recovery, seeking to foster financial conditions that would facilitate a good expansion in economic activity without aggravating in any way the troublesome problem of inflation. That is still our basic policy.

In my report to this Committee last November, I announced the ranges of growth for the major monetary aggregates that the Federal Open Market Committee had projected for the year ending with the third quarter of 1976. In the case of M_1 -- that is, the money stock defined so as to include only currency and demand deposits -- a range of 5 to 7-1/2 per cent was projected. For M_2 -- which also includes time and savings deposits other than large certificates of deposit at commercial banks -- the range was set at 7-1/2 to 10-1/2 per cent; and for M_3 -- which encompasses, besides the components of M_2 , the deposits at savings banks, credit unions, and savings and loan associations -- a range of 9 to 12 per cent was set.

Looking back over the past year, we find that the actual pace of monetary expansion was broadly in line with the specified ranges. During the year ended in the third quarter of 1976, M_1 grew 4.4 per cent, somewhat below the lower end of the projected range. On the other hand, M_2 rose 9.3 per cent, a little above the mid-point of its range, while M_3 grew 11.5 per cent, or close to the top end of its range.

The shortfall in the growth of M_1 from the projected rate reflects innovations in financial technology that spread through the financial system more rapidly than we anticipated. For example, the spread of overdraft facilities at banks has tended to reduce the volume of demand deposits held by the public for transactions purposes. So also has the growth of NOW accounts in the New England region, the development of telephonic transfers of funds from savings to checking accounts, and the growing use of savings deposits to settle monthly bills for utilities, mortgage obligations, and other recurring items. Moreover, recent regulatory changes, which permitted commercial banks to accept savings deposits by business corporations and state and local governments, have resulted in a substantial increase in savings accounts. A significant part of these deposits effectively serve as transactions balances.

The Board's staff has sought to estimate the effect of innovations of this kind on the recent growth of M_1 . These estimates are necessarily rough. They suggest, however, that growth of M_1 over the past year would have been 2 percentage points higher -- or about $6\frac{1}{2}$ instead of $4\frac{1}{2}$ per cent -- in the absence of these developments.

A year ago there was some concern among the members of Congress and other interested citizens that the growth ranges of the monetary aggregates we had projected would lead to a marked tightening of credit conditions. That has not occurred. Interest rates usually begin to rise at about the time when general business activity turns up. In the present instance, however, market interest rates have generally remained below their level in the spring of 1975, when the economic recovery began. Indeed, interest rates on short-term securities are about as low now as at any time in the past four years. In longer-term markets, yields on high-grade corporate bonds are about $1\frac{1}{2}$ percentage points below their level at the beginning of the recovery. In fact, they are lower than at any time in the past $2\frac{1}{2}$ years.

The downward tendency of interest rates during the current economic expansion stems, in part, from the fact that private credit demand -- especially the demand by business firms for short-term funds -- has remained moderate. The main cause, however, of the unusual behavior of interest rates during this recovery is the gradual lessening of inflationary fears and the consequent reduction in the inflation premium 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. Commercial banks have 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.

The liquidity of savings banks and savings and loan associations has also improved markedly. The flow of savings to these institutions has remained abundant, and they have continued to increase their mortgage lending. Outstanding mortgage loan commitments of savings and loan associations -- the leading suppliers of home mortgage credit -- are now at the highest dollar figure in history.

Our Nation's business enterprises have likewise taken advantage of the prevailing financial climate to improve their financial condition. During the past two years, corporations issued a huge volume of long-term bonds, and they have used much of the proceeds to repay short-term debt and to acquire liquid assets. Since early this year, 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.

These accomplishments in financial markets indicate, I believe, that the course of moderation in monetary policy pursued over the past year has significantly 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 need 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. During the early 1970's, the underlying inflationary trend was aggravated by a variety of special factors -- poor crop harvests here and abroad, a world-wide boom in economic activity, devaluation of the dollar in international exchange markets, and an enormous run-up in the prices of gasoline, fuel oil, and other energy items brought on by the OPEC cartel. By 1974, the general price level was rising at an explosive rate.

In 1975, our Nation finally succeeded in reducing the rate of inflation -- with the increase of consumer prices slowing to 7 per cent from the 12 per cent rise recorded in 1974. Most of this notable progress occurred in the first half of 1975.

Since then, there has been little further improvement in the underlying rate of inflation. Thus, consumer prices have risen during the past several months at an average annual rate of around 6 per cent, and the advance of wholesale prices of industrial commodities has been still faster. Energy prices are again rising rapidly; since April, the cost of energy items to consumers has increased at an annual rate of 15 per cent.

Last quarter, the average level of prices of all items included in the gross national product rose less than in the second quarter. This improvement, however, mainly reflected technical factors. With the underlying rate of increase in the general price level still around 6 per cent, inflation continues to erode the purchasing power of the wages and savings of our people at a disconcerting rate.

Continued progress in unwinding inflation must remain a major objective of public policy, along with reestablishment of reasonably full employment and reasonably full utilization of our industrial capacity. Experience around the world indicates that these goals are inseparable -- that lasting prosperity cannot be attained in a highly inflationary environment.

The principal contribution that the Federal Reserve can now make to the achievement of our Nation's basic economic objectives is to adhere to a course of moderation in monetary policy. With that in mind, the Federal Reserve has made several adjustments over the past year in its projected long-run growth ranges for the monetary aggregates. These adjustments were in large part designed to take account of the changes in financial technology that I discussed earlier, but by pointing gradually downward they also moved in a direction consistent with an eventual return to general price stability.

The Federal Open Market Committee has now adopted ranges for the year ending in the third quarter of 1977 that differ only a little from those announced last July. For M_1 , the upper boundary of the projected growth range was reduced by one-half percentage point, so that the new range is 4-1/2 to 6-1/2 per cent. This reduction reflects the fact that changes in financial technology are likely to continue reducing the proportion of transactions balances held by the public in the form of currency and demand deposits. Therefore, an increase of M_1 as large as 7 per cent over the next year would not be needed to finance a continued good recovery -- and it might well contribute to a revival of inflationary expectations. The change thus constitutes one more small but prudent step toward achievement of a monetary growth trend consistent with a gradual return to general price stability.

For technical reasons, the upper boundary of the ranges for the broader measures of money has been raised by one-half percentage point. The projected range for M_2 is now 7-1/2 to 10 per cent, and for M_3 the range is 9 to 11-1/2 per cent. These adjustments were dictated by the fact that market interest rates have recently declined, while those paid by banks and thrift

institutions on time and savings deposits (other than large certificates of deposit) have generally remained at regulatory ceilings. The diversion of savings funds from market instruments to deposits at these institutions has therefore been unexpectedly large, so that growth rates of M_2 and M_3 have of late tended to exceed their longer-run ranges. We cannot be sure that these higher growth rates of M_2 and M_3 will continue, but there is no reason at present to be seriously concerned about them.

Let me take this opportunity to state unequivocally once again that further reductions in the growth ranges of all the major monetary aggregates will continue to be needed if the United States is to succeed in unwinding the inflation that still plagues our economy. We at the Federal Reserve are mindful of this basic consideration.

In the course of this review of economic and financial developments, I have tried to indicate that our Nation has made considerable progress over the past year and a half in restoring prosperous conditions. Much remains to be accomplished, however. In recent months the rate of economic expansion has been retarded, new jobs have not been created at a sufficient pace, and unemployment has risen.

I remain entirely optimistic about our Nation's ability to deal successfully with these problems. There are, however, uncertainties at the present time that cloud the prospects for a strong recovery of economic activity next year.

One concern is the possibility that the pace of inflation may accelerate. Over the past three months, wholesale prices of industrial commodities have risen at an annual rate of 11 per cent. Continuation of anything like that rate would erode confidence and induce businesses and consumers to reduce their spending commitments.

A related concern is the threat of a further increase of OPEC oil prices. If the OPEC cartel raised prices an additional 10 to 15 per cent, as has been rumored, the adverse effects on the recovery of business activity could be serious -- in other countries as well as our own. An increase of that magnitude would add to the strains that have already been brought on in international markets by the continuance of high rates of inflation in numerous countries. Banks and other private lenders here and abroad may be unable to extend a sizable volume of additional loans to foreign borrowers without going beyond the boundaries of prudent management. International financial mechanisms may

encounter difficulties in handling still larger or more widespread balance-of-payments deficits. These considerations must be kept sternly in mind by the political and financial leaders of both the oil-exporting and oil-importing nations.

As we at the Federal Reserve Board now observe the world scene, there is a clear need for expansion in the economies of both the industrialized and the developing nations. Both here and abroad, the recovery from the deep recession of 1974-75 has been incomplete.

The participants in the recent meetings of the International Monetary Fund in Manila wisely recognized the dilemma presently faced by economic policymakers throughout the world. In today's environment of deeply-ingrained inflationary expectations, traditional policies of economic stimulation might well be counter-productive. Fears of inflation would intensify, and the seeds of another recession may be sown. As the Interim Committee of the International Monetary Fund observed this October, "in present circumstances the restoration of a reasonable degree of price stability will be necessary to establish the basis for sustained economic growth and the reduction of unemployment."

The Federal Reserve Board continues to believe that structural changes in our economy would enhance the prospects for returning to reasonably full employment without releasing a new wave of inflation. 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 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 practical training programs, and other realistic 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 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 could aid in the restoration of general prosperity. For example, there is a large contribution to be made by serious efforts on the part of business managers, trade union leaders, officials of local governments, and other public-minded citizens to work cooperatively together to help train unskilled workers and find them jobs, to stimulate new businesses in the central cities, to restore the pride of Americans in their local communities, and to deal on a broad front with the vast problem of urban decay.

These and other structural reforms could often be accomplished with no adverse impact on the Federal budget. I cannot stress too strongly the importance of being cautious in launching new Federal programs with a potentially large budgetary impact. There is a clear need for fiscal discipline at the present stage of our struggle with inflation. Reform of Congressional budgetary procedures has been of great value in obtaining better control over Federal expenditures. The next important step in the process of budgetary reform, I believe, would be to move toward zero-base budgeting.

Progress in the field of structural policies is a matter of urgency. Our Nation cannot long tolerate high rates of unemployment and inflation. The policies for stimulating employment on which we have relied heavily in the past -- such as budget deficits and easy credit -- cannot work well in an environment that has become highly sensitive to inflationary fears and expectations. The Board therefore urges the Congress 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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