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Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance, and Urban Affairs

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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.

When I last met with you in July 1976, the growth of economic activity had begun to slow perceptibly, after a year of brisk recovery. At that time, I noted that the balance of economic forces suggested an early return to stronger rates of expansion in production and employment. The favorable turn of events during the past several months indicates that our economy is, in fact, emerging from the recent pause.

Periods of retardation in economic growth, followed by a renewed upsurge of economic activity, have been a fairly common feature of business-cycle expansions. In 1962, for example, the growth of output slowed markedly for several quarters, but a more rapid pace resumed in 1963. Earlier, economic expansion appeared to falter in late 1951 and early 1952, and then picked up with some vigor. Looking back still further to the business cycles before World War II, we find that periods of retarded growth and subsequent resurgence frequently occurred during the longer phases of economic expansion.

The improvement in the condition of the national economy over the past several months is due in some measure to the impetus provided by governmental policies. Monetary policy remained accommodative throughout 1976. Indeed, open-market operations by the Federal Reserve sought late last year to encourage somewhat more ample supplies of money and credit. Also, the discount rate on loans to member banks was reduced in November, and reserve requirements on demand deposits were again lowered in December. By promoting some easing of conditions in the money and capital markets at a time of business hesitation, these actions helped to bolster the state of business and consumer confidence.

Fiscal actions also became more stimulative during the latter half of 1976. Expenditures of the Federal Government, as measured in the national income and product accounts, fell short of official projections during the first half of last year. Later in the year, as a part of the earlier shortfall was made up, Federal expenditures rose rather rapidly.

These facts deserve only passing notice. The noteworthy feature of the recent pick-up in business activity is that it mainly resulted from the normal workings of self-corrective forces within the private economy. Last summer, many manufacturers curtailed production of items for which inventories were rising too rapidly. Retailers, in their turn, offered price concessions to consumers and increased their advertising in order to stimulate sales. Before long, consumers began to respond energetically. Retail sales regained strength in October, and then moved up substantially further in the closing months of the year.

Homebuilding activity, which has been in an upward trend since early 1975, also rose significantly late last year, in response to improving conditions in the mortgage and real estate markets. The strong underlying demand for housing -- especially in sections of the country experiencing rapid population growth -- led to a rapid increase in sales of new and existing homes and to a rising level of new starts for both single-family and apartment dwellings. Total housing starts during the last three months of 1976 advanced nearly 15 per cent from the preceding quarter and reached the highest level in more than 3 years.

Thus, despite some weakening in the pace of business investment in fixed capital, the physical volume of final purchases -- that is, all purchases of goods and services except for additions to inventories -- rose at an annual rate of almost 5 per cent in the fourth quarter. This was the most rapid advance of any quarter during 1976. The strengthening of final purchases enabled business firms across the nation to work off a good part of the excess inventories that had accumulated over the preceding months. True, the aggregate volume of business inventories rose further in the fourth quarter, but the rate of advance was much slower than in the summer and much slower also than the increase in final sales. This reduced pace of inventory accumulation, along with strikes in some major industries, was responsible for a disappointing performance of physical output during the final quarter of last year. But it set the stage for a return to a more vigorous rate of economic expansion by bringing sales and stocks into better balance.

Actually, the pace of orders and production has already begun to quicken. New orders for durable goods began moving up in November and rose sharply further in December. The output of our Nation's factories, mines, and power plants also rebounded sharply in November, as the depressing impact of major strikes abated; and another strong advance of production was registered in December.

Conditions in labor markets were improving noticeably around year end. Employment rose briskly in December, and unemployment declined across a range of industries. The reduction in unemployment among heads of households was particularly encouraging. A strengthening of demand for labor has also been evident in the recent declining rate of layoffs and the rising pace of new hires at manufacturing establishments. With employment growing more rapidly, the volume of personal income during the fourth quarter rose at an annual rate of nearly 11 per cent -- half again as fast as in the previous three-month period.

Activity in the current quarter is being adversely affected by plant shutdowns in many parts of our country as a result of shortages of natural gas and other fuels. The difficulties imposed on many American families by the bitterly cold winter will be long remembered, but I do not expect large or lasting effects on the performance of the economy during 1977.

Thus, further good gains in economic activity seem very likely during the course of this year. Consumers are now spending more freely: the percentage of disposable personal income spent on goods and services during the fourth quarter was the highest in several years. Except for areas where the weather has been unfavorable, retail sales during January appear to have continued at a satisfactory pace. Moreover, consumers have built up their stock of liquid assets substantially during the past year, and they have also been cautious in adding to their debts. The overall financial condition of the household sector has thus improved, and this will contribute to stronger consumer markets in the months ahead.

Prospects for residential construction are also bright. Construction of single-family homes has already rebounded sharply, and production of multi-family units is now gradually recovering from overbuilding and the other problems that had been troubling this sector. Mortgage credit is in ample supply. Commitments by thrift institutions for home mortgage loans are at record levels; the inflow of savings to these institutions is continuing at a high rate; and mortgage interest rates are gradually declining. Housing starts should therefore continue to move up at a good pace.

Our export trades, too, can be expected to improve during 1977. Many foreign economies experienced a retardation of growth last year just as we did, and they too are likely to enjoy a pickup in the tempo of activity relatively soon. The demand for our exports should therefore increase. Of course, our imports will also be increasing as the domestic economy continues to expand, so that our net trade balance may not improve appreciably during the course of this year. The growth of imports, however, is not expected to be as rapid as it was in 1976, and net income from services should increase further. Thus, our deficit on current account with other countries will probably be rather moderate in 1977.

Business spending should contribute substantially to economic expansion this year. Inventory investment may proceed at a cautious pace for a little while longer; but with consumer purchases continuing to grow satisfactorily, business firms will soon have to add substantially to their inventories.

Outlays for plant and equipment should also strengthen as 1977 unfolds. During the course of this recovery, businessmen have been planning for the future with considerable caution. Additional hesitancy developed last summer when the pace of expansion slowed, and a few firms postponed new projects while some others stretched out their capital expenditure programs. These attitudes are now changing. Confidence has been strengthened by President Carter's firm statement rejecting wage and price controls, as well as by the recent trend of business developments.

I feel reasonably confident that 1977 will be a good year for the Nation's economy, but this is no time for complacency. Much remains to be accomplished. Although the proportion of our adult population holding jobs has been rising, more than 7 million people are still out of work, and our labor force is growing very rapidly. Last year, women entered the labor force in exceptionally large numbers, and the total number of individuals at work or seeking employment rose on an unprecedented scale -- by 2.8 million.

Although unemployment is widespread, the inflation from which our country has also been suffering has not come to an end. Despite heartening progress over the past two years, prices are still rising at a troublesome rate. In 1976, consumer prices on the average rose about 5 per cent -- down from 7 per cent in 1975 and 12 per cent in 1974. But the American people are not content to live with a 5 per cent rate of inflation, nor should they be. If the general price level were to continue rising at a rate of 5 per cent a year, the value of a family's savings -- or the purchasing power of a retiree's pension check -- would be cut in half in just 15 years. Worse still, if a 5 per cent rate of price advance were to be accepted complacently by Government, inflationary expectations would intensify, and the actual rate of price increases would then almost certainly move toward higher levels.

Unfortunately, it will be difficult to achieve a significant reduction in the rate of inflation in the immediate future. Wholesale prices of industrial commodities rose during the past half year at an annual rate of over 9 per cent. At the consumer level, prices of heating fuels and gasoline have of late been rising rapidly again. As the pace of economic activity quickens in coming months, pressures could develop for larger and more widespread increases in wages and prices than we have recently experienced. The outlook for prices is thus a worrisome matter, and it must be given very careful attention. For a durable prosperity will not be achieved in our country until we gain better control of the inflationary forces that have damaged our economy for more than a decade.

There are several other longer-range problems to which public policy must attend. During the past decade, increases in the output per manhour in the private sector have averaged less than 2 per cent a year -- a substantial decline from the 3 per cent rate achieved during the preceding decade. There are numerous reasons for this sorry performance. For one thing, the work habits of the American people are not what they once were: absenteeism is a growing problem for many firms, and there are other manifestations of less dedication by workers. Another reason is that the expansion and modernization of our industrial plant has been inadequate. Last year, our country devoted less than 10 per cent of its total output of goods and services to the production of new plant and equipment. Other industrialized nations have been committing a much larger fraction of their resources to capital formation than we -- and they have also been experiencing faster economic growth.

Public policy must also come to grips with the need to revitalize our central cities, with the need to reform a welfare system that has become chaotic and inordinately costly, and with the need to strengthen our national security by regaining substantial independence in the energy area. Energy consumption is rising rapidly again, and the recent very cold weather has reminded us poignantly of the critical role played by supplies of natural gas and petroleum in our economy. The shortage of natural gas is now receiving constructive attention from the

Congress. But, unfortunately, we are still at the mercy of a few oil-exporting countries; in fact, our dependence on foreign sources of oil is substantially larger now than at the time of the 1973 oil embargo.

We will not solve this or our other longer-term problems simply by loosening the Federal purse strings and letting the money roll out. That course would sooner or later accelerate inflation and thereby create other, and perhaps even greater, economic problems. It should be abundantly clear by now that a healthy and prosperous economy can be achieved only by pursuing policies that are consistent with steady progress toward restoration of general price stability.

That principle is continuing to guide Federal Reserve policy. Over the past year, growth rates of the major monetary aggregates have not been excessive, and our projected ranges for the future have been gradually reduced. This course of action, by dampening inflationary expectations, has helped to restore public confidence -- both here and abroad -- in the value of our currency and in the future of our economy.

Mainly as a result of this lessening of inflationary fears, interest rates have not increased as they usually do in a period of cyclical expansion. In fact, the level of interest rates on short- and long-term securities is appreciably lower now than it was at the beginning of economic recovery in 1975.

Thus, the monetary policy we have pursued has fostered conditions in financial markets that have aided the process of economic recovery. Supplies of credit have been ample. In fact, the volume of funds raised by the nonfinancial sectors of the economy has increased considerably faster than the dollar value of the gross national product. Meanwhile, the financial condition of business firms has improved materially; and financial institutions have rebuilt their liquidity, so that they will be able to accommodate a substantial rise of credit demands in the months ahead.

The growth rates of major monetary aggregates have remained relatively close to those we had expected earlier. In the year ended in the fourth quarter of 1976, M_1 -- that is, the money stock defined narrowly so as to include only currency and demand deposits -- rose 5.4 per cent, somewhat below the midpoint of the range projected a year ago. In contrast, M_2 -- which also includes savings and consumer-type time deposits at commercial banks -- increased 10.9 per cent, just above the upper end of its projected range. Growth of M_3 -- a still broader measure of money that encompasses, besides the components of M_2, the deposits at savings banks, savings and loan associations, and credit unions -- amounted to 12.8 per cent, and also exceeded its range by a small margin.

There was an unusually wide gap during this past year between the growth rates of M_1 and the broader monetary aggregates. This stemmed in large measure from changes in financial markets that have served to reduce reliance on demand deposits for handling monetary transactions. Recent financial innovations have important implications for the conduct of monetary policy, and it may therefore be worthwhile to comment on them.

Elements of the innovational process currently under way in financial markets can be traced as far back as the early 1950's. When interest rates rose during the cyclical upswing of 1952 and 1953, some large corporations began to invest their spare cash in Treasury bills. In subsequent years, more and more firms increased their efforts to develop better systems of cash management, so as to minimize holdings of demand deposits which -- under existing law -- bear no interest. In time, individuals began to emulate business practices -- by shifting idle funds into liquid market securities or savings deposits.

In the late 1950's and early 1960's, the innovational process was accelerated by more aggressive efforts of commercial banks, especially the larger institutions, to bid for loanable funds. Major efforts were made to attract the highly interest-sensitive funds of corporations and other large depositors. For example, banks in the money market centers began in 1961 to sell large-denomination certificates of deposit on a significant scale; and a secondary market, which soon developed for these instruments, enhanced their acceptability.

With inflation pushing interest rates to extraordinary heights during the past decade, both business firms and individuals have intensified their search for ways to minimize holdings of noninterest-bearing assets. Financial institutions, meanwhile, have been competing actively to meet the public's needs. As a consequence, the innovational process has accelerated. An array of new financial instruments and practices has developed that has enabled the public to hold an increasing fraction of its transactions balances in interest-bearing form.

For example, the so-called NOW accounts have grown steadily in the New England States, and they serve effectively as checking accounts for many individuals. Smaller businesses and State and local governments nowadays hold a significant part of their cash balances in the form of savings accounts at commercial banks -- which only recently were granted authority to accept such deposits. Moreover, many individuals are learning to use savings accounts for transactions purposes by making payments through third-party transfer arrangements, or by telephonic transfers of funds from savings to demand deposits to cover newly written checks. Others are using money-market mutual funds for the same purpose. And still others have worked out overdraft arrangements with their banks to reduce the amount of funds held in demand deposits bearing no interest.

In projecting its monetary growth ranges, the Federal Open Market Committee has had to keep these developments of financial technology carefully in mind, because they affect the rates of growth of monetary aggregates that are needed to sustain economic expansion. At its meeting about two weeks ago, the Committee adopted ranges for the year ending in the fourth quarter of 1977 that differ only a little from those announced last November. For M_1, the previous range of 4-1/2 to 6-1/2 per cent has been retained. For M_2 and M_3, the lower boundaries of the ranges were reduced by a half percentage point. Consequently, the new range is 7 to 10 per cent for M_2 and 8-1/2 to 11-1/2 per cent for M_3.

The downward adjustment of the lower boundary of the ranges for M_2 and M_3 largely reflects technical considerations. By historical standards, growth of the broader measures of money in 1976 was relatively rapid in relation to growth of

M_1. Over the course of last year, M_1 rose 5.4 per cent, very close to the 5.6 per cent average of the preceding ten years. But M_2 increased 10.9 per cent in 1976, in contrast to an average yearly rise of 8.3 per cent over the preceding decade; and M_3 increased 12.8 per cent, in contrast to an average annual increase of 8.8 per cent in the preceding ten years.

It seems likely that growth rates of these broader aggregates will move back toward historical norms in 1977. Last year the growth of M_2 and M_3 was influenced by shifts of existing stocks of financial assets from market securities to time and savings deposits. This adjustment of assets may not go much further. Moreover, some banks and thrift institutions, having experienced larger inflows of funds than they can readily invest, have of late taken steps to slow deposit inflows -- by reducing the interest rate offered on savings certificates and deposits, or by curtailing promotional activity, or in other ways. These actions should tend to moderate the growth of M_2 and M_3 this year without impairing the flow of funds for homebuilding.

Besides these technical considerations, the adjustment of the lower limit of the projected ranges for M_2 and M_3 reflects the Federal Reserve's firm intention to continue moving gradually toward rates of monetary expansion that over the longer-run are consistent with general price stability. The step we have taken on this occasion is a very small one, but it may still bolster the confidence of the public in the commitment of the Federal Reserve to do what it can to unwind the inflation from which our economy continues to suffer.

The projected range for M_1 in the year ahead reflects our assumption that the financial innovations now in train will continue to reduce materially the proportion of transactions balances that are held in the form of currency and demand deposits. If our assumption is correct, the range we have projected for M_1, together with the ranges projected for M_2 and M_3, should be adequate to finance a faster rate of growth of physical production in 1977 than we experienced in 1976. I must note, however, as I have repeatedly in the past, that profound uncertainties surround the relationships among the various monetary aggregates, and between rates of monetary expansion and economic performance. We shall therefore monitor emerging developments closely, and stand ready to modify our projected growth ranges as circumstances may dictate.

Let me also take this opportunity to state once again that substantial further reduction in growth rates of all the major monetary aggregates will be needed over the next few years if our Nation is to succeed in halting inflation. The long-run growth rate of physical production at full employment has declined in recent years, and is probably around 3-1/2 per cent at present. Judging by the experience of the past two or three decades, a stable price level would require a rate of expansion in M_1 that over the long run is well below the growth rate of total output. Growth rates of the broader monetary aggregates consistent with general price stability might be somewhat higher than long-term growth of output; but in any event they would have to be far below the rates experienced in recent years.

Our Nation needs to make progress during 1977 in creating more jobs and in expanding our industrial capacity. We at the Federal Reserve fully recognize this fact, as our recent policy actions have made clear. We are also mindful of the need to make further progress in the battle against inflation. Highly expansionist policies that seek to achieve striking gains in economic activity with little or no regard to their inflationary consequences are apt to fail. Once inflationary expectations are inflamed, conditions in financial markets will deteriorate, and the confidence of businessmen and consumers will be eroded. Hopes for a sustained economic recovery would then be undermined.

Public policy must find a middle ground. Deficits in the Federal budget must be scrupulously watched and gradually reduced. Growth in supplies of money and credit must also be brought down gradually to rates consistent with general price stability.

Our Nation has paid a heavy price for permitting inflation to get out of control in the late 1960's and early 1970's. We must not lose sight of that fact. The substantial progress we have made in slowing inflation since 1974 has helped to heal our economy. Gradual restoration of price stability is within our means. Unless we stay on that course, the lasting prosperity to which the American people aspire will continue to elude us.

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