For release on delivery

Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

February 23, 1977

As always, I welcome the opportunity to meet with this distinguished Committee to present the views of the Federal Reserve Board.

Your deliberations this year take place at a time when the interpretation of statistical information has been made especially difficult by the vagaries of the weather. While that is troublesome, there is good reason, I believe, to feel a sense of encouragement about underlying trends in our Nation's economy. We at the Board are especially pleased that the financial situation stands out as a significant positive factor in the economic outlook for the year ahead.

The task for monetary policy in the recent past has been clear -- to facilitate a substantial expansion in economic activity, while guarding against the release of new inflationary forces. In its pursuit of that basic objective, the Federal Reserve has fostered moderate rates of monetary growth. During the period extending from the cyclical trough of March 1975 to January of this year, M_1, the narrowly defined money stock -- which includes only currency and demand deposits -- grew at an annual rate of 5.7 per cent. A broader monetary aggregate, M_2 -- which also includes savings and consumer-type time deposits at commercial banks -- increased at a 10.7 per cent rate. Contrary to the predictions of many economists who urged a more expansionist monetary policy, these increases in the stock of money have proved sufficient to finance a large gain in the physical volume of output and employment. Indeed, the evolving stock of money could readily have accommodated larger growth in economic activity than actually occurred.

The Federal Reserve's moderate policy, by damping 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. The dollar is once again a respected currency in international markets. The demand for U.S. securities and other dollar-denominated assets is again strong. And the substantial increase in the exchange value of the dollar since the recovery began has relieved some of the upward pressures on the general price level in this country.

Moreover, and mainly as a result of the lessening of inflationary expectations, interest rates have not increased as they usually do in a period of cyclical expansion. On occasion during the past two years, yields in securities markets have registered noticeable upward movements -- sometimes, as last month, because of shifting market expectations or the pressures of heavy Treasury borrowing, at other times as a result of Federal Reserve actions intended to hold monetary growth within desirable bounds. But the general trend has been downward, and the level of market interest rates on both short-term and long-term securities is appreciably lower now than it was at the beginning of the economic recovery.

Declines in interest rates have not been confined to public markets for securities; they have extended also to loans by financial institutions. Interest rates have come down on residential mortgage loans. The rate of interest on bank loans to borrowers of the highest credit rating has declined sharply. Rates paid by other bank customers are also down; in fact, at the end of last year, interest rates on loans to small businesses and farmers were at, or very near, their lowest levels since 1973.

Meanwhile, the stock market has shown a good recovery. Despite some decline since the beginning of this year, the average price of a share on the New York Stock Exchange at present is more than 65 per cent above its 1974 trough. A large measure of financial wealth has thus been restored to the millions of individuals across our land who own common stocks.

Our Nation's business enterprises have taken advantage of the prevailing financial climate to improve their liquidity. Corporations have issued a huge volume of long-term bonds, and they have used the proceeds largely to repay short-term debt and to acquire liquid assets. For a time, access to public markets for long-term funds was confined primarily to firms with the highest credit ratings. During 1976, however, lower-rated firms began to find a more receptive market for their debt issues; the yield spread between Aaa- and A-rated bonds, which was 1-1/2 percentage points when the recovery began, has averaged only about 1/2 percentage point since last summer. In addition, many medium-sized firms, as well as firms with lower credit ratings, have met their needs for long-term funds in the private placement market where life insurance companies and other institutional lenders have extended a record volume of credit.

Besides this, the improved stock market has made it much easier for corporations to raise equity funds for financing new investment projects or for rebuilding capital cushions. The dollar volume of corporate stock flotations in 1976 was far above the depressed level during the recession. By following conservative dividend policies, business enterprises also have been able to add substantially to their retained profits, and debt-to-equity ratios of corporations have generally declined.

The market for State and local government securities was troubled in late 1975 and early 1976, when the New York City financial crisis made investors very cautious and drove up borrowing costs to many states and their political subdivisions. Since then, interest rates on municipal securities have declined sharply -- more sharply, in fact, than interest rates on other fixed-income obligations. In addition, the spread between yields on higher- and lower-quality issues of municipal securities has narrowed. Record volumes of new tax-exempt bonds were sold in 1975 and 1976, in part to pay off short-term debt. These repayments, as well as the progress made in strengthening budgetary positions, have improved the standing of State and local governments with the investment community. In addition, the recent court decision setting aside the moratorium on certain of New York City's debt repayments has added materially to the confidence of investors in the safety of State and local obligations.

The condition of financial institutions has also improved over the past two years. Commercial banks, for example, have greatly increased their liquidity by doubling their holding of Treasury securities and reducing their reliance on volatile sources of funds. With greater attention to canons of prudent management, banks have achieved moderate increases in profits -- even in the face of substantial loan losses and larger allocations to reserves for possible future losses. A large share of bank profits has been used to enhance capital positions, so that the ratio of capital to risk assets, which had declined steadily during the early 1970's, has risen appreciably. These changes have done much to enhance public confidence in the soundness of the Nation's banking system.

Other depositary institutions have made similar progress in strengthening their financial condition. Savings and loan associations, in particular, have repaid large amounts of debt besides adding heavily to their holding of liquid assets. Furthermore, with savings inflows continuing very ample, the thrift institutions have stepped up their mortgage lending to a record level. Outstanding loan commitments are at an all-time high, and mortgage rates have continued to edge downward despite the huge volume of mortgage borrowing and the recent upward movement in sensitive market rates of interest.

In sum, it is clear that the financial base for economic activity has greatly improved. That, of course, is a highly important positive factor in the general economic outlook.

Other factors also suggest the likelihood of gathering economic strength as 1977 unfolds. During the closing months of last year, the demand for goods and services -- except for inventory additions -- picked up, reflecting primarily a resurgence in consumer buying and a further strong advance in homebuilding. The higher level of sales enabled business firms across the Nation to work off a good part of the excess inventories that had accumulated over the preceding months. With sales and stocks coming into better balance, the pace of orders and production began to quicken and the demand for labor strengthened. We thus began this year with employment and incomes increasing briskly.

During the past month or so, jobs, output, and sales have been adversely affected by cold weather and interruptions of fuel supplies. In some parts of the country, drought conditions have led to the rationing of water and may later affect some branches of agriculture as well as the cost and availability of hydroelectric power. Although the weather is leaving a mark on household budgets through its impact on incomes, fuel bills, and food prices, the overall economic effect seems to be considerably less than has been suggested by many news headlines. In fact, production and employment have already snapped back smartly in most places.

The hardships imposed on many American families by this inclement winter will be long remembered and, I hope, will stimulate long-needed action on a national energy policy. The recent difficulties, however, are not likely to have large or lasting effects on the performance of the economy during 1977.

Most major sectors of demand can be expected to contribute to the expansion of economic activity over the remainder of the year. Consumers have been showing an inclination to spend more freely; during the fourth quarter, the percentage of disposable personal income devoted to consumer spending was the highest in several years. Except in areas where the weather has been especially unfavorable, retail sales since the beginning of the year have continued at a satisfactory pace. Moreover, consumers have built up their stocks of liquid assets substantially during the past two years. With their financial condition thus improved, they are now displaying an increased willingness to incur added indebtedness in order to finance the purchase of automobiles and other big-ticket items.

The strong pace of consumer buying during the Christmas season resulted in a sharp decline in the ratio of inventories to sales in many lines of activity. Stocks of some goods probably have been further depleted in recent weeks because of production curtailments caused by weather and fuel problems. Business-men may be reluctant to reorder in volume until they are more confident that the economy has regained its upward momentum. But as sales rise, they will soon have to add substantially to their inventories in order to meet customer demands.

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 the overbuilding and other problems that have been troubling this sector. Mortgage credit is readily available in practically all parts of the country, and residential building activity should therefore continue to move upward.

The outlook is less clear for the demand for U.S. exports. Our merchandise trade balance fell sharply last year -- in large part because of our increasing dependence on foreign sources of oil and the weak revival of economic activity in many other countries. During 1977, imports will increase as the domestic economy continues to expand, but the rise is not likely to be as rapid as last year. Our export trade can be expected to improve, with the extent of the gain depending on the pace of worldwide economic expansion.

At present economic recovery is underway abroad, but the recovery in many countries is less decisive than in the United States. In a number of instances, less vigorous economic growth reflects actions taken to cope with inflation and severe imbalances in international payments. Among other difficulties, the process of adapting to the harsh reality of much higher oil prices is by no means complete. Thus, our export trade may be adversely affected for some time, particularly since credits to many foreign countries cannot very well continue rising as rapidly as they have in recent years.

There is much less uncertainty about the outlook for investment in business fixed capital in our country. Indeed, the near-term prospect is clearly favorable. It is our judgment at the Board -- based on the continuing improvement of product markets, the intentions of business firms disclosed by survey data, the upward trend of capital-goods ordering, the increasing number of new firms, and the improved state of financial conditions -- that business capital investment will grow significantly over the remainder of this year and into 1978. There is some question, nevertheless, as to just how vigorous or how durable the rise may be.

Historically, investment in plant and equipment has often increased rapidly even in the early stage of cyclical expansions. In the current recovery, however, business capital outlays have been sluggish; measured in constant dollars, they rose only 3 per cent through the final quarter of 1976. This contrasts with an average increase of 15 per cent during corresponding periods of the earlier business-cycle expansions since World War II. Of late, businessmen have been especially hesitant to commit themselves to major investment undertakings. The capital spending that has occurred so far in this expansion has been heavily concentrated in relatively small-scale items -- for instance, office equipment, light machinery, and trucks. Relatively few large-sized industrial or commercial construction projects have been recently started.

I believe that a major reason for the inadequate expansion of plant and equipment spending is 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 experienced an economic decline of comparable severity. In recent times, the view spread in business circles, as it already had in the academic community, that the business cycle was dead -- that any recession that might occur would prove brief and mild, because governmental policies could be relied upon to keep the economy moving forward at a rather steady pace. Businessmen certainly were unprepared for the slump in sales and production in late 1974 and early 1975 that resulted from an inflationary process that had gotten out of control. In the aftermath of this hard experience, it is not surprising that corporate managers became more cautious in their planning and that rebuilding of the confidence needed for a new surge of investment activity is taking time.

This pattern of events has been world-wide in scope. Industrial nations generally have suffered a cycle of inflation and recession similar to that in the United States, and businessmen everywhere have since then tended to be unusually cautious in making major long-term investment commitments. During the past year, economic expansion in most countries has been held back by weakness in business capital outlays.

Contributing to this lack of confidence is the fact that, despite heartening progress over the past two years, inflation is still proceeding at a troublesome rate almost everywhere. In 1976, consumer prices in this country rose about 5 per cent. This was down from 7 per cent in 1975 and 12 per cent in 1974. But our businessmen as well as other citizens fear that the continuation of even a 5 per cent rate of inflation may be incompatible with the attainment of a durable prosperity. In an inflationary environment such as we have had in recent years, many business managers are apt to feel that they cannot reliably assess costs and profits over the long time horizons frequently involved in new investment projects. This inevitably affects their investment planning.

In addition, businessmen have been concerned for some time about the possibility of an early reintroduction -- in one form or another -- of price and wage controls. I sense, however, that this particular apprehension has diminished, thanks in large measure to President Carter's perception that concern about controls was complicating the process of business decision making.

I must note also that governmental regulation has become an important deterrent to capital spending. Businessmen tend to shy away from costly investments whose useful economic lives may be cut short by the introduction of more stringent safety, health, or environmental standards. Rigid price regulation -- as in the natural gas and transport industries -- has served to reduce the incentives for investment. And the failure of the Federal Government to formulate a coherent, long-range energy policy has left the business community troubled and uncertain about the future cost and availability of fuels and petroleum feedstocks.

Furthermore, compliance with existing environmental and safety regulations adds to the cost of building and operating productive facilities -- without increasing their salable output. These costs involve not only expensive equipment -- such as pollution control devices -- but also the time lost in going through extensive governmental review procedures. I understand that any given industrial construction project may be subject to as many as ten different environmental regulations at the Federal level alone. And overlapping regulations at the Federal, State and local levels, besides causing confusion and delay, sometimes work at cross purposes. This tangled regulatory system has caused some extraordinary delays both in the launching and completion of major capital projects.

The consideration of remedies deserves high priority. We must find the political courage to consider objectively not only the very real benefits of environmental and safety regulations, but also their economic costs.

We should give serious consideration as well to reform of our system of Federal taxation in order to reduce the disincentives to business capital formation and to equity investment in American enterprises. The current Congressional study of proposals for integrating the personal and corporate income taxes is a step in the right direction. I hope that the Congress will also examine the distorting effects of inflation on the corporate income tax, which have contributed to the weakness in after-tax earnings of our businesses over the past decade.

It may be well to emphasize that the Nation's stock of industrial capital has been growing too slowly not just during the current recovery but over a period stretching back at least to the beginning of this decade. The volume of business fixed investment per person added to the labor force was appreciably smaller between 1970 and 1975 than it had been between 1960 and 1970. This unquestionably has affected the trend of productivity, which has been decidedly disappointing in recent years.

What should concern us perhaps most of all is the distinct possibilty that a continued lag in capital formation will make the attainment of full employment of our labor force extremely difficult further along in the current expansion -- simply because we may have a deficiency of plant capacity relative to available labor. It is important, therefore, to focus intently on the whole range of problems relating to capital formation. Senator Humphrey and Senator Percy wisely called attention to this need last year by introducing S. 3693, the "Investment Policy Act of 1976," -- a bill that stresses the importance of creating an environment that is more conducive to business capital formation.

The steps here suggested will not suffice, however, to bring about a lasting improvement in the level of investment activity if our Nation fails to pursue fiscal and monetary policies that promise continuing progress in moderating inflation. Forward business planning, which is extremely challenging under the best of circumstances, becomes exceptionally hazardous in an inflationary environment of the kind that has existed in our country since the mid-sixties. Nor for that matter can there be satisfactory planning in such an environment by households or governments. Many of the problems that our cities have been living with are traceable to the stresses of inflation in the early 1970's -- specifically, to the ballooning of costs for municipalities whose tax revenues, unlike those of the Federal Government, respond sluggishly to inflation.

In conducting fiscal and monetary affairs, we in the Federal Government must not allow ourselves to be lulled into thinking that stimulative actions are riskless because there is now considerable slack in the economy. As we should know by now, pressures on resources and prices can arise even at a time of substantial unemployment.

For its part, therefore, the Federal Reserve System is committed to a course of monetary policy that will permit sufficient growth of money and credit to support good expansion in economic activity, but which will avoid the release of new inflationary pressures or expectations. On the fiscal side, it is no less imperative that budgetary deficits be gradually reduced and before long eliminated. If they are not, anxieties about the future path of inflation may threaten the hard-won progress that has been achieved in improving the condition of our financial markets and the over-all economy. As our economy continues to expand, a significant and steady lessening of Federal Government demands on capital markets will be vital to release savings for use in the private sector of the economy. The supportive role which government appropriately plays at a time of extensive unemployment, such as we have been experiencing, must be scaled down as the Nation moves toward fuller utilization of its resources.

No problem more urgently requires our attention than the unemployment of some 7 million Americans. But we must be skeptical of solutions that require ever-larger governmental deficits or ever-faster money creation.

Fortunately, understanding of the complexities of our Nation's economic problems has grown as a result of the hard lessons of recent years. If all of us in government work together and share ideas, I am optimistic that we can fashion policies that will go far toward strengthening the state of confidence on which the jobs and prosperity of our people ultimately rest.

* * * * * * * *