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Statement by

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It is a particular pleasure, Mr. Chairman -- and I do not say that lightly -- for me to meet with this Committee. For many years, I joined other citizens in urging a reform of the budget process, so that tax and expenditure decisions of the Congress would become effectively linked. Passage of the Congressional Budget Act of 1974 was a major landmark in financial reform -- comparable in importance, I think, to the Budget and Accounting Act of 1921 which rationalized budgetary procedures for the Executive Branch. In my judgment, the experience of the last two years confirms the wisdom of the 1974 innovation. The new element of order and discipline that this Committee, your counterpart in the Senate, and the Congressional Budget Office have brought to fiscal deliberations has served the American people well. We finally have a mechanism for determining Congressional priorities and relating expenditures to prospective revenues.

Today, I would like to share with you my views about evolving trends in economic and financial conditions and to spell out the implications, as I see them, of those trends for some of the critical economic policy questions that confront our Nation.

This winter's unusual weather has, of course, greatly complicated the interpretation of statistical data. For a while, jobs, output, and sales were significantly affected by cold weather and interruptions of fuel supplies, especially in the eastern half of the country. And in parts of the West, drought conditions have necessitated the rationing of water and may later affect some branches of agriculture and also the cost and availability of hydroelectric power.

These vagaries of the weather have left their mark on household budgets through their impact on incomes, fuel bills, and food prices. The over-all economic effect, however, in all probability will prove considerably smaller than many news accounts initially suggested. The period of acute disruption of industrial and commercial operations was, after all, brief, and as we meet here today, production and employment appear to have recovered in most places. While I am sure that the hardships imposed on many American families by this winter's extraordinary weather will long be remembered, it seems most unlikely that the disturbance we have suffered will have large or lasting effects on the performance of our economy.

There is good reason, I think, to feel a sense of encouragement about the way in which underlying economic conditions are unfolding. Before the advent of inclement weather, the economy was already emerging from the phase of hesitancy that prevailed for a while last year. During the closing months of 1976, the demand for goods and services -- except for inventory additions -- accelerated, reflecting primarily a resurgence of consumer buying and a further strong advance in homebuilding. The improvement in sales volume enabled business firms to work off a good part of the excess inventories that had accumulated over preceding months when buying was fairly sluggish. With sales and stocks coming into better balance, the pace of orders and production began to quicken and the demand for labor strengthened. This reacceleration of the recovery was the consequence, in my judgment, of gradually cumulating strength in key sectors of our economy and an improved financial environment. I believe that we shall see evidence before long that the reacceleration has survived the weather disturbance, and I expect good gains to be recorded in general economic activity this year.

Emerging trends in the consumer sector were strongly favorable as this year began. The considerable expansion in jobs last year, also the decline in the rate of inflation and the enlarged liquid assets of households, served to improve consumer sentiment. It seems reasonable to think that it is those trends -- rather than the transitory effects of bad weather -- that will basically condition household behavior in the months ahead. A quickening tempo, as I have noted, developed in late 1976 for both incomes and employment. This created the basis for more aggressive retail buying. Indeed, reliance on instalment credit to finance purchases of consumer durable goods increased in late 1976; and, strikingly, the personal saving rate for the fourth quarter fell to its lowest reading in several years.

One consequence of the buying surge was that inventories toward the close of last year fell below levels preferred by many business firms. In some instances further depletion of stocks has since then occurred because of the production curtailments occasioned by bad weather and fuel problems. Very possibly, therefore, considerable inventory investment by businesses lies ahead.

The major influences that affect residential construction are also favorable. Indeed, except for January's weather-related setback, housing activity has been in a strong upward movement since last autumn. The swelling of new housing starts in the fourth quarter of 1976 -- to a rate, incidentally, 30 per cent greater than a year earlier -- assures that work on homes under construction will be very active for a good many months to come. And some further rise in starts is a reasonable expectation, in view of the liquid condition of mortgage-lending institutions and the progressive correction of the imbalances in the housing market that arose during the early 1970's.

The outlook for business capital spending in 1977 is also promising, even though serious questions can be raised as to the likely adequacy of capital formation in our country over the longer term. So far in the current recovery, capital spending has been lagging; measured in constant dollars, it rose by only 3 per cent through the final quarter of 1976. This contrasts with an average rise of 15 per cent during the corresponding periods of earlier business-cycle expansions since World War II. However, the average rate of gain should be decidedly better during the next year or so.

This judgment is based on a number of considerations -- the continuing improvement of product markets, the intentions of business firms to invest as disclosed by survey data, the increasing number of new firms that are starting up operations, the comparatively favorable cash position of corporations, and an impressive uptrend in capital-goods ordering. Contracts and orders for plant and equipment, a leading indicator of investment activity, spurted at an annual rate of more than 20 per cent in the fourth quarter of last year, and monthly data covering new orders for nondefense capital goods show the rise continuing in January. To be sure, the level of capital-goods production is still far short of what we normally might expect at this stage of cyclical expansion, but we can at least anticipate that it will make a larger contribution to the advance of the general economy this year than it did in 1976.

It is much more difficult to reach a confident judgment about how exports and imports will impinge on our Nation's economy this year. In 1976, both exports and imports rose considerably, but our export trade was held back by the weak expansion of many foreign economies. The rise in imports was far more pronounced, reflecting in significant part our increasing

dependence on foreign sources of fuel. Some further decline in our trade balance and also in the broader current account balance is likely this year, but not nearly to the degree that occurred in 1976.

The challenge facing our exporters is formidable because of the continuation of less decisive recovery tendencies abroad than here at home. In some instances, less vigorous economic growth reflects actions taken by foreign officials to cope with severe inflationary problems and the accompanying imbalances in international payments. An important drag on recovery in numerous countries is the ongoing adjustment, as yet far from complete, to the quantum jump of oil prices since 1973. Thus, our export trade may be adversely affected for some time, particularly since the external indebtedness of many nations cannot continue rising as rapidly as it has in recent years.

But with the exception of these uncertainties relating to foreign trade, factors on the demand side generally seem to point to good growth in our Nation's output this year. Buttressing that expectation is the fact that over-all financial conditions in this country -- an area in which the Federal Reserve System has a major responsibility -- provide a satisfactory foundation for economic growth.

The basic objective of monetary policy in the recent past has been to promote conditions conducive to substantial expansion in economic activity, while guarding against the release of new inflationary forces. To that end, the Federal Reserve has fostered moderate rates of monetary growth. During the period extending from the cyclical trough of March 1975 to February of this year, M_1 , the narrowly defined money stock -- which includes only currency and demand deposits -- grew at an annual rate of 5.6 per cent. A broader monetary aggregate, M_2 -- which includes as well savings and consumer-type time deposits at commercial banks -- increased at a 10.7 per cent rate.

These increases in the stock of money have proved adequate 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. In that connection, it is important to bear in mind that consideration of the stock of money alone is not sufficient for assessment of the adequacy of the economy's liquidity. Money has a second dimension, namely, velocity, or -- in common parlance -- the efficiency with which it is being used. For the narrowly defined money supply, efficiency of use

has been improving with special rapidity in recent years, reflecting numerous innovations in financial technology that serve to reduce reliance on demand deposits for handling monetary transactions. In fact, during the span of the current recovery, the gains recorded in the efficiency of M_1 appear to have exceeded typical gains during corresponding periods of past cyclical upswings.

Major benefits have flowed from the Federal Reserve's carefully fashioned monetary policy. By holding resolutely to a course of moderation -- a policy that at times has run counter to strongly voiced urgings that we be much more expansionist -- we have helped in very significant degree, I think, to dampen inflationary expectations. This has strengthened public confidence -- both here and abroad -- in the value of our currency and in the future of our economy.

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, both short- and long-term interest rates have registered noticeable upward movements, but the general trend has been downward in the yields on securities traded in public

markets and also in the interest charges on loans extended by financial institutions. In general, interest rates are appreciably lower now than they were at the beginning of the economic expansion -- a fact that augurs well for the continuation of recovery. One of the considerations brightening the housing outlook, for example, is that the average rate on residential mortgage loans across the country has come down almost 1-1/2 percentage points from its earlier high. Also important to the housing outlook is the fact that the rates paid by mortgage-lending institutions to their depositors remain attractive relative to money-market obligations, so that no threat exists -- at least for the immediate future -- of heavy shifts of funds out of such institutions.

Significantly, our Nation's business enterprises have made good use 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. They have also greatly increased the volume of stock flotations above the depressed level during the recession. Supplementing these actions, business enterprises have followed generally

conservative dividend policies, thereby retaining substantial amounts of current earnings for internal use. The consequence of this combination of moves is that corporate balance sheets have a much healthier look now than they did several years ago. The average maturity of outstanding corporate debt has been lengthened appreciably, and businesses now also have more equity relative to debt. This clearly puts business firms in a good position to expand the scale of their operations as opportunities arise. For a while the improvement in liquidity occurred mainly in the case of firms enjoying the highest credit ratings and therefore having the easiest access to longer-term funds; but the improvement has progressively become a generalized phenomenon.

The favorable condition of financial markets has been of important help as well to the Nation's State and local governments. Record volumes of new tax-exempt bonds were sold in 1975 and 1976, in part to pay off short-term debt. Those repayments, together with progress made by many States and municipalities in strengthening their budgetary positions, have improved the standing of such governments with the investment

community. Testifying to that is the fact that interest rates on municipal securities have not only declined; they have declined more sharply 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. These developments suggest that the demand for goods and services by States and municipalities -- which was relatively subdued during the past several years of difficult adjustment -- will now expand somewhat more rapidly.

During the past two years, the Nation's financial institutions have also strengthened their capability to be supportive of economic expansion. Commercial banks have materially improved their liquidity by doubling their holdings of Treasury securities and reducing reliance on volatile sources of funds. They have, moreover, retained a large share of profits 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. Other depository institutions have made similar progress in strengthening their capacity to respond to financing requests. Savings and loan associations, for instance, have repaid large amounts of debt besides adding

heavily to their holdings of liquid assets. With savings inflows ample, thrift institutions have already stepped up their mortgage lending to a record level, and they clearly are going to have considerable scope to accommodate further the demands for mortgage credit in 1977.

In sum, both the background of favorable financial conditions prevailing at this time and the growth patterns that have been unfolding in key sectors of our economy justify considerable optimism about the immediate future. Indeed, it seems doubtful to me, as I have previously indicated, that any special efforts to stimulate growth -- at least none of conventional character -- are now needed to assure broad economic expansion this year and on into 1978.

I realize that a majority of this Committee, as well as the able members of President Carter's economic team, feel differently. I thoroughly respect their judgment as well as yours. In matters pertaining to the future, no sensible person can be at all certain that he has captured the truth. As things stand, I diagnose the condition of our economy somewhat differently, and it is my duty to advise you as I best can.

I believe that we can all agree that, in wrestling with the policy challenges that face our Nation, no objective deserves higher priority than that of creating job opportunities for the millions of Americans who want to work but who nevertheless now find themselves idle. But while the goal we seek is clear, appropriate actions for dealing with unemployment are not easy to devise or to carry out.

By my diagnosis, as I have already noted, our economy faces a serious deficiency of business investment in fixed capital, rather than any generalized problem of demand deficiency. The underlying difficulty is that we have done many things over a span of years which have been damaging to the state of confidence -- especially the confidence of the business community. Efforts at fiscal stimulation do not seem promising to me in these circumstances. Indeed, they could prove inimical to real progress, if only because they are likely to be perceived by many people as an extension of the loose budgetary practices from which so many of our troubles derive.

By and large, the American public is familiar with the sorry record of Federal Government finances in our generation. More and more of our citizens have come to appreciate the linkage between the record of persistent deficit financing and the debilitating inflation of recent years. The degree to which we have been unwilling to tax ourselves -- even in good years -- to finance the programs enacted by the Congress never ceases to astonish me, no matter how often I scan the figures. Only once since 1960 has the Federal budget shown a surplus. The cumulative deficit in the unified budget over the past fifteen years, including the newly revised official estimate for the current fiscal year, comes to \$308 billion. If the spending of off-budget agencies is also taken into account, as it should be, the aggregate deficit for the period amounts to \$337 billion.

We have built momentum into the rise of Federal expenditures by the enactment of "entitlement" programs relating to income security and health and by extending inflation escalator clauses to a significant range of Federal programs. The merit of many of these responses to the needs of our citizens is indisputable, but the impetus thus imparted to

budgetary expansion is nevertheless very serious. It underscores the imperative need for us to be extremely cautious in adding new programs to the budget. In stressing this principle, President Carter deserves your and the Nation's full support. But it is equally important that the Congress ponder carefully any abrupt surrender of sizable amounts of tax revenue.

The inflation that has plagued the American economy since the mid-1960's is a complex phenomenon, and it is by no means solely the product of budgetary practices. But there can be little doubt that the chronic reaching of the Federal Government for both financial and real resources has been a major contributory element in inflation -- indeed, the dominant one in my judgment. The Federal Government was a party -- rather than the counterweight it should have been -- to the demand pressures that began building up in the mid-sixties and that culminated in the speculative distortions of the 1973-74 period. Inflation, by my assessment, not only sowed the seeds of the recession that ensued; it also is the basic explanation -- precisely because it became so virulent -- of why the recession that followed was so severe. Blinded by

the explosive advance of prices -- which for a while swelled nominal profits -- businessmen were unusually slow in adapting their activities to the weakening pattern in consumer markets that had actually become quite well-defined during 1973. When businessmen finally recognized in the autumn of 1974 that their perception of market conditions had been mistaken, the response in scaling back operations was often drastic -- in large part because distortions had been allowed to cumulate for such a long period.

A strong residue of caution has been evident in business circles since then. That caution -- which explains, I believe, the relatively weak recovery in capital spending so far in this expansion -- is an amalgam of several things. These include the rude discovery that the business cycle is by no means dead, a heightened worry about the troubles inflation can breed, apprehension about the cost and availability of energy supplies, a lingering fear that expansionist governmental policies could again lead to price controls, and growing concern about the costs of complying with existing environmental and safety regulations. In short, a confident business mood has been slow to emerge in the aftermath of recession, in considerable

part for reasons that relate to our recent history of inflation and government's role in that history. The consumer mood is stronger; but consumers, too, have anxieties about inflation and inflation-inducing actions by government.

What this analysis suggests to me is that governmental consideration of economic policy should focus sharply on ways and means of strengthening the confidence of our people in their own and the Nation's economic future. By focusing as we have on the size of a "stimulative" fiscal package, we inadvertently have been diverting attention from what I believe to be the main problem. At this juncture of history, government actions should aim above all else at reassuring our citizens that the policy mistakes of the past will not be repeated. Indeed, from the viewpoint of the responsibilities of this Committee, a consideration of what not to do again ought, I believe, to serve as the critical point of departure for policy formulation.

Starting there, I obviously cannot feel comfortable about the official budget for fiscal 1977, or for that matter about any budget, which moves toward enlarging the Federal deficit. This prospective enlargement comes at a time -- unlike that of 1975 -- when private credit demands are rising. Thus, a troubling departure is occurring from the normal

pattern of gradually diminishing demands for credit by the Federal Government as recovery proceeds.

On the basis of the revised budget proposals submitted by the Administration, it would appear that Federal borrowing in public markets in the current calendar year could be \$10 billion or so higher than in 1976. The prospect that Federal demand for credit will run considerably higher than earlier seemed likely has stirred uneasiness among credit market participants, as is evidenced by the decline in prices of fixed-income obligations that followed disclosure of the Administration's intentions. While a "crowding out" of private borrowers from credit markets does not seem a serious threat, at least not for 1977, the enlarged prospective competition of the Federal Government with private borrowers -- with the housing sector, for instance -- is most unwelcome. It may impart some upward tendency to interest rates, and it will also make it more difficult for the Treasury to achieve further progress in lengthening the maturity of outstanding debt.

I have felt obligated in the course of this statement to explain to you why, on the basis of my interpretation of the events that have occurred during recent years, I have reservations about budget moves that do not yet have the appearance

of breaking with the past. Whatever early action is taken in the Congress with regard to the budget, I hope that the point I have made about the vital need for confidence-building actions will carry some weight in your continuing deliberations as the year goes on. To give Americans confidence that the future will be something other than a repetition of the past, government must demonstrate in a persuasive way that it is regaining control of our fiscal affairs.

The President's commendable goal of a balanced Federal budget within four years might still be within reach even if the budget is now enlarged by the full amounts that have been recommended. The task of holding to that timetable will, however, be made more difficult by each and every enlargement of spending. This emphasizes the need for an especially cautious approach to requests for program increases -- both now and in the future. In that regard, I particularly want to applaud the President's decision to go forward with a zero-base budget system for fiscal 1979, and also to review very critically the current practice of allowing off-budget outlays. These steps should serve to reduce, if not eliminate, programs that have outlived their usefulness.

Such a budgetary approach, it seems to me, has great potential for helping arrest the powerful upward push of Federal spending. For the record, I would note that the Federal Reserve has for some time been conducting two pilot studies of the feasibility of adopting zero-base budgeting ourselves. One of those studies is going forward at the Chicago Federal Reserve Bank and the other in a division of the Board. While evaluation will take some time, I am inclined to think that we may be able to move to the recommended approach fairly rapidly, even though as an independent agency we have no formal obligation to do so.

In closing, I would like to come back for a moment to the workings of the new Congressional budget system. I am aware, of course, that the proposal for a Third Concurrent Resolution for fiscal 1977 has been subjected to some fairly sharp criticism. To the extent that such criticism has been directed at the specific content of the resolution, it seems entirely proper. Indeed, as I have made clear here today, I take some exception myself to its basic thrust. The legitimacy of having a third resolution, however, does not seem to me to be open to question. If a judgment emerges after

acceptance of a particular concurrent resolution that some significant change has occurred in national conditions, a reopening of that resolution for revision is a clearly proper and responsible action.

I would voice, however, one cautionary word. As a practical matter, if the Congress were to move in the direction of very frequent revision of concurrent resolutions, the essential discipline of the new budgetary process would be lost. It may be useful to recall that the only previous effort by the Congress to operate with a formal legislative budget -- under the Legislative Reorganization Act of 1946 -- foundered in part because liberal supplemental appropriations made the whole exercise of spending ceilings by concurrent resolution somewhat pointless. While I do not think there is great risk that we shall travel such a route again, I mention that bit of history because it is so vital that the new legislative budget process continue to evolve along the lines of its promising beginnings. The last two years have clearly demonstrated the value of the legislative budget as an instrument for bettering fiscal discipline. This Committee has earned the Nation's gratitude by its commitment to that objective.

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