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Statement by

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

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It is a special pleasure for me, Mr. Chairman, to meet with this Committee. The action taken by the Congress in 1974 to establish a formal legislative budget is one of the great events of our time. In my judgment, the work of this new Committee and of your counterpart in the House has already amply demonstrated the wisdom of the Congressional Budget Act.

In August of 1976, when I last communicated with this Committee, there was considerable concern in our country over the slowing in the pace of economic recovery. I then called attention to the fact that temporary pauses were not uncommon during business-cycle expansions, and went on to suggest that reacceleration of economic growth would probably occur soon because improving conditions were discernible in key sectors of the economy.

It is clear now that a quickening of the economic tempo did occur in the latter months of 1976. Retail sales began to show improvement last autumn across a broad spectrum of merchandise lines, and by Christmas it was evident that consumers generally were in a spending mood. Brisk consumer buying during the fourth quarter enabled business firms to work off excess inventories that had accumulated during previous months when retail demand was weaker. With sales and inventories coming into better balance, production and new orders began to quicken and the demand for labor increased. Employment rose strongly in the final two months of last year and again in the first two months of this year -- with the cumulative rise over the four months amounting to 1-1/4 million persons.

These developments testify to the fact that as 1977 began, our Nation's economy was already emerging from its phase of slowing. That fact would be better appreciated, I believe, were it not for preoccupation with gross national product numbers as such. The figure for the fourth quarter of last year was obviously disappointing, showing as it did an annual rate of gain of only 2.6 per cent in constant-dollar terms. That outcome, however, reflected the inventory adjustment that was in progress. When inventory changes are removed from the gross national product figure -- in other words, when we focus on final sales of goods and services -- we have a better indicator of the underlying trend of the economy. This magnitude showed a decidedly stronger rate of gain in last year's final quarter -- an annual rate of growth of 5.7 per cent. Indeed, when one abstracts from the inventory changes that overlay broad economic trends during the course of 1976, the picture of steadily improving final sales is impressive. And it would have been even more impressive, I believe, had it not been for the distortions caused by strikes in the rubber and automobile industries. It is noteworthy that the annual rate of growth in final sales, measured in constant dollars, rose in successive quarters of 1976, while the corresponding figures for GNP kept declining.

For a brief period, the unusual weather of January and February tended to obscure the reacceleration under way in the Nation's economy. January numbers, in particular, were badly distorted, and, of course, we still do not know how seriously agricultural production will be affected this year by the drought in parts of the West. Recent data, however, preponderantly confirm a smart snapback from the weather-related disturbances, and we may reasonably expect good gains in general economic activity during the remainder of this year and on into 1978.

The economy is now relatively free of the kind of speculation and imbalances that developed in the early 1970's. Consumer purchasing power -- badly hurt for some years by inflation's heavy toll -- is exhibiting a healthier trend. So too is business income. Material improvement has occurred in personal and corporate balance sheets. Inventories in general seem to be prudently related to sales trends. The housing industry is steadily working out of the difficulties brought on by the over-building of the early 1970's. Even business investment -- while lagging in its recovery pace relative to earlier business-cycle expansions -- is gradually gaining strength. And, I might add, the financial environment in our country is now conducive to economic expansion, as is evidenced both by the state of liquidity that generally prevails and by the truly striking fact that the level of interest rates is appreciably lower than at the beginning of the recovery.

In view of this combination of circumstances, as I have indicated in other recent Congressional testimony, it seems doubtful that any special governmental efforts are now needed to assure substantial gains in our economy this year. A few months ago, when plans aimed at bolstering aggregate demand first began to take shape, the case for supportive action had greater plausibility. But some significant developments have since then occurred -- particularly, of course, the demonstration that economic expansion is reaccelerating and that the re-acceleration has apparently survived the weather disturbance.

Such reservations as I or others at the Federal Reserve have about the immediate need for new fiscal stimuli should not be interpreted to mean that the Federal Reserve will stop short of doing what it can to foster a satisfactory rate of economic growth this year. On the contrary, as I have repeatedly stated, the President's objectives for 1977, with regard to both the growth of output and decline of unemployment, appear to be entirely reasonable.

The growth ranges that we at the Federal Reserve have established for monetary expansion this year, as reported to the House Banking Committee in February, are adequate in our judgment to permit a significantly faster rise in physical output during 1977 than occurred during 1976. For M_1, the narrowly-defined money stock -- which includes only currency and demand deposits -- the Federal Open Market Committee (FOMC) has specified a growth range of 4-1/2 per cent to 6-1/2 per cent for the year ending with the fourth quarter of 1977.

For M_2, a broader measure of money which includes as well savings and consumer-type time deposits at commercial banks, the range is 7 to 10 per cent. For M_3, a still broader aggregate which includes also the deposits of thrift institutions, the range is 8-1/2 to 11-1/2 per cent.

It is highly important to recognize that the ability of these monetary aggregates to accommodate economic growth depends not just on their size, but also on the intensity with which money balances are used -- that is, on the turnover of money. The turnover of the narrowly-defined money stock -- or, if you prefer, its velocity -- has been rising especially rapidly in recent years, reflecting numerous innovations in financial technology that have enabled individuals and business firms to reduce reliance on demand deposits for handling their monetary transactions. Our judgment is that such economizing in the use of cash balances will continue, and -- of necessity -- we must take that consideration into account in setting our monetary expansion ranges.

The growth ranges that the FOMC has established for monetary growth are, of course, not immutable. Large uncertainties always surround economic forecasts, and the relationships that exist between financial and real variables are complex and often loose. For these reasons we are very mindful at the Federal Reserve that constant reappraisal of the appropriateness of our monetary growth ranges is required. Should developments in the months ahead indicate that the ranges established for monetary expansion are inconsistent with the achievement of satisfactory performance of our economy, the FOMC would alter them -- either upward or downward, depending on what signals emerge. Indeed, a formal detailed review of our longer-term monetary growth ranges occurs every three months, with the next such review scheduled for the FOMC's mid-April meeting.

The judgments that go into our process of reassessing monetary growth rates are literally continuous, and they are not made lightly. The members of the Federal Open Market Committee make the final decisions, but in doing so we rely heavily on the investigations and knowledge of our excellent staff. We also benefit greatly from the knowledge and experience of the officers and directors of the Federal Reserve banks and branches across our country.

I want to assure you, moreover, that committee meetings such as today's are very helpful to us in clarifying Congressional intent and purpose. So, too, are the oversight hearings conducted by the banking committees of Congress. The Federal Reserve does not operate in an ivory tower. We well understand the need for checking and expanding our knowledge, and we therefore supplement interchange of the kind we are having today with a great deal of informal contact with individual members of Congress and with officials of the Treasury Department, the Council of Economic Advisers, the Office of Management and Budget, and other agencies. Such dialogue is, in fact, continuously occurring.

The subject of money and banking can at times be difficult even for experts. I recall vividly the questions concerning monetary policy raised by some members of this Committee soon after the disbursal of the tax-rebate and special Social Security checks in 1975. Since pending legislation before the Congress would involve another substantial rebate program this spring, it may be helpful to review the earlier episode and at the same time share with you our plans for adjusting monetary actions to this year's proposed rebates.

The objective of the Federal Reserve in 1975 was to accommodate as smoothly as possible the sudden large flow of funds through bank accounts occasioned by the rebate program. This involved action to supply bank reserves to the market in the period before the rebate checks were mailed, since the Treasury was then building up its balances at Federal Reserve banks in anticipation of making the disbursements. Had we not acted supportively in the pre-rebate period, total bank reserves would have tended to fall -- as would private holdings of money -- and interest rates would have been subjected to upward pressure. For the rebate period itself, our intent was to allow the depositing of rebate checks in bank accounts to go forward without any special effort on our part to influence the impact of such deposit activity on money growth. We recognized, of course, that the money supply would accelerate significantly for a while, but we also anticipated that it would subsequently moderate as households and businesses disposed of deposits that had temporarily risen above accustomed levels.

As events actually unfolded in May and June of 1975, the rise that took place in the money supply was much larger than the Federal Reserve staff had estimated would occur as a result of the rebate program. The inference we drew was that the demand for money was expanding rapidly quite apart from the rebate program. We therefore took mildly restrictive action toward the end of June to reassure the Nation that the Federal Reserve would not countenance monetary expansion on a scale that might release a new wave of inflation. Differences of judgment existed then -- and still do -- as to the appropriateness of that mild tightening action. Let me say only that if we erred, the mistake was technical in origin -- that is, it grew out of the difficulty in making good estimates of the tax-rebate impact on deposit growth. In any event, monetary growth rates soon moderated, and we lost very little time in returning to an easier monetary stance.

Fortunately, in judging the monetary effects of this year's proposed rebate program, we have a better basis for making estimates because the 1975 experience is available for guidance. Whereas our 1975 estimates of how money supply growth would be affected were single-point estimates, this time we will make a range of estimates in recognition of the uncertainties inherent in trying to gauge how much of their rebates people will elect to hold in money form and for what length of time. In short, I expect that our zone of tolerance in permitting monetary expansion to run at high rates for a while will be somewhat wider this time. But if we then find that monetary growth does not soon moderate in expected degree, we may need to take action to absorb bank reserves temporarily. All in all, my belief is that we learned something in 1975 and that consequently a rebate program this year has a good chance of being handled relatively smoothly.

A basic working premise of the Federal Reserve is that there is an urgent national need to create job opportunities for the millions of Americans who want to work but who nevertheless now find themselves idle. The solution of this problem, and especially amelioration of the difficulties that young people have in finding employment, is not to be found exclusively -- or even mainly -- in government programs aimed at enlarging aggregate demand. It is of crucial importance that our citizens understand better than they do that inflation is itself a prime source of much of our nation-wide unemployment.

There is no doubt in my mind, as I read the record of the early 1970's, that inflationary distortions were the principal cause of the recent severe recession. Nor do I have much doubt that the expansion of employment now in process will be threatened if we fail to develop a strong anti-inflation policy.

That is why monetary policy, while fully supportive of economic growth, has diligently sought to avoid the release of new inflationary forces. That is also why I have been so concerned that the Congress recognize the powerful momentum that has been built into Federal spending by the "entitlement" programs enacted in the 1960's. We need to take great care in adding new permanent programs to the budget, lest they accentuate underlying budget pressures that will manifest themselves later on and create financial stresses that jeopardize economic growth and employment.

Fortunately, we have made considerable progress since 1974 in lowering the rate of inflation. Consumer prices rose about 5 per cent last year, down from 12 per cent two years earlier. But it is going to be difficult to achieve further significant reductions in the immediate future. Substantial amounts of idle capacity and manpower provide little assurance that price pressures will not mount as the economic growth rate speeds up. Indeed, the historical record of business cycles in our country clearly demonstrates that the average level of sensitive commodity prices tends to start rising at or close to the very beginnings of a business-cycle upswing and that the prices of final goods and services gather substantial upward momentum well before full utilization of resources is achieved.

We are now witnessing in fact some disturbing manifestations of price pressures in our economy. The prices of basic commodities in wholesale markets have been moving up at a rapid pace since last fall. The wholesale prices of industrial commodities at all stages of processing have increased at an annual rate of 8 per cent during the past half year. At the consumer level, even abstracting from the temporary impact of weather on some food items, there has been a tendency recently for prices of many goods and services to rise at an increased rate.

These developments suggest the need for great care in fashioning fiscal and monetary policies. Our official actions must not contribute to inflationary psychology. Not only that, but we need to convince both businessmen and consumers that a break with the past is under way -- particularly, that our Nation's finances will henceforth be handled with greater prudence than they have in the past.

The task of effecting a transition to a noninflationary environment is one to which the Federal Reserve must make a major contribution. The monetary growth ranges established during the past two years have been considerably higher than they should be over the long run. Ideally, the combination of increases in the money stock and increases in velocity should approximate the economy's longer-term growth rate of physical output, which is about 3-1/2 per cent. If we could come close to such an alignment, the trend of the general price level would tend to stabilize and inflation would be a thing of the past.

We are, of course, a long way from that objective and, as a practical matter, we cannot move to it in one fell swoop. The shock of adjustment would be too abrupt in view

of the need to keep the economy moving along a satisfactory path of expansion. But the difficulties inherent in moving swiftly to appropriate growth rates for money do not mean we should be acquiescent. Rather, a policy of gradual reduction in monetary growth rates toward levels consistent with reasonable price stability must be adhered to. The Federal Reserve has in fact been gradually lowering its projected growth ranges for the monetary aggregates.
We know that we must do better in order to lay a foundation for lasting prosperity. I assure you that we will be striving in that direction.

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