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Statement by

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Before the

Committee on the Budget

House of Representatives

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It is a privilege for me to appear before this Committee today. First of all, let me take this occasion to commend the work achieved last year by the Budget Committees. The implementation of the new Congressional Budget Act, I believe, is off to an excellent start. The growing acceptance of your new procedures will help the Congress to consider the Federal budget as a whole and to evaluate its economic implications. Your Committee is playing a vital part in this accomplishment of great importance to the American economy.

Over the last nine months the United States' economy has again demonstrated its capacity to recover from economic adversity. The vigorous pace of the recovery is indicated by the nearly 9 per cent average annual rate of growth in real GNP that occurred during the second half of last year. This is the fastest growth rate in any half-year period since the cyclical upturn in late 1958. The recent growth in economic activity was accompanied by a 1.3 million increase in total employment from the low point reached last March. Nevertheless, the rate of unemployment at year end remained at the distressingly high level of 8.3 per cent. In part the slow progress in reducing unemployment reflects a 1-1/2 per cent increase in the labor force during 1975, considerably in excess of historical precedent for this stage of the business cycle. Families' real incomes and savings had been eroded by inflation and efforts to bolster them helped to increase the number of persons seeking jobs.

The recent gains in economic activity have been based on expanding demands in most areas of the economy. Increases in employment and reduced tax burdens last year raised real disposable income for the first time since 1973, and thus supported higher aggregate consumption. Most recently, high retail sales during the Christmas season and continued large commercial purchases in January gave evidence of underlying strength in this sector. Housing, as you know, has also staged a substantial recovery, especially for single-family units. Activity in this sector started from such a low point, however, that residential construction still is relatively weak. The continuing high volume of exports, despite reduced economic activity abroad, indicates a new competitiveness for American goods and services, and bodes well for rising demands from this source in the future.

Changes in business inventory investment strongly interacted with movements in final demands during 1975 and accounted for a large portion of the cyclical swing during the year. Data for the fourth quarter indicate that the huge inventory liquidation that depressed economic activity in the first half of the year has about run its course. In many lines of nondurable goods, inventory/sales ratios are close to historic lows and inventories of these products are generally being replenished. Stocks of durable goods are still being reduced, but over-all the prospects are for a return to inventory accumulation during 1976.

Investment in plant and equipment, while sharply reduced during the recession, showed its first increase in real terms last quarter. Such increases are likely to gain momentum as higher levels of economic activity make their impact on business sales. I am aware of the very cautious investment plans reported for 1976 in the December Commerce Department survey, but I think it most likely that businessmen will revise their plans upward on the basis of favorable sales and profits experiences as has happened in prior cyclical recoveries.

State and local governments as a group continued last year to increase moderately their purchases of goods and services in real terms. This happened despite the well-known financial difficulties of some individual units. Employment in this sector, moreover, rose 5 per cent from its 1974 average, partly reflecting Federal inducements to public service employment.

On the price side, some moderation was achieved last year. Nevertheless, progress in reducing inflation has been disappointing, considering the extent of slack in the economy. The current rate of inflation, broadly viewed, appears to be on the order of 7 per cent a year. While this represents a very sizable reduction from the 12 per cent inflation rate in late 1974, a significant part of the moderation during this period has been due to diminishing pressures in special areas, such as oil, farm products, and other raw materials. Moreover, a great deal of the reduction in the pace of inflation occurred in the first half of 1975. More recently there has been a disturbing pick-up in prices of industrial commodities at the wholesale level. From now on, further reductions in the rate of inflation will be more difficult to achieve because prices will tend to reflect unit labor costs. While increases in labor compensation moderated somewhat during 1975 to around 8 per cent, they were still far above the pace of long-term productivity gains. This upward pressure on wages has been indicative of an effort to maintain real incomes in the face of still substantial price advances. Thus wages and prices continue to push each other up.

Real wage increases, over time, will tend to match productivity gains. Good increases in productivity should accompany a sustained recovery. The resultant pronounced improvement in real wages should lessen nominal wage demands. This would permit a winding down of the wage/price spiral.

More generally, prospects for continued deceleration of inflation depend on avoiding renewed overheating of the economy. The consensus view now is that recovery will proceed at a moderate rate through this year. This will help to avoid the rekindling of inflationary pressures. Diminishing inflation will be an essential factor in sustaining the expansion over a prolonged period.

In evaluating the outlook for private spending, it is relevant to consider the progress that has been made in correcting the serious financial imbalances carried over from the late 1960's and early 1970's. These arose as a consequence of accelerating inflation and the rising interest rates which inevitably grew out of that pattern of price behavior. Household wealth in real terms was reduced as the purchasing power of fixed dollar claims declined and as common stocks lost value even in terms of current dollars. Business cash flow was impaired because bookkeeping profits -- reflecting inventory gains and underdepreciation -- occasioned higher taxes, without providing spendable funds to business. The unbalanced financial position of many enterprises limited their ability to finance capital expansion by borrowing while at the same time it became more difficult to build equity, whether by selling new shares or retaining earnings.

To overcome these financial injuries, businesses and households worked hard last year at rebuilding liquidity and net worth. Household savings rates remained well above historic levels while businesses used the funds obtained through heavy borrowings in long-term markets to retire a large amount of short-term debt. They also limited their capital expenditures to levels nearly matching internally generated funds. Financial institutions, including banks, went through a similar process of improving their liquidity and their capital positions.

Over time, successful financial restructuring may accelerate household and business spending. In order to improve their financial position, these units may have postponed purchases of durables and capital equipment. Once they feel more comfortable financially, they may well be disposed to make up these backlogs. That possibility imparts an underlying strength to the economic outlook. It also poses a risk, however, that spending could accelerate unduly as the economy approaches higher levels of capacity utilization. This outlook reinforces the case for a policy of moderation in the ongoing expansion.

The main task of over-all fiscal policy in promoting and protecting a sustainable recovery, under the circumstances, is to bring down the massive current Federal deficit. A fiscal posture appropriate to the requirements of such a recovery will also serve to maintain balance in financial markets. As recovery progresses, these markets will need scope to supply funds that match the expanding needs of private borrowers. An excessive deficit would run the risk, first of once more generating excessive expansionary pressures and eventually, if interest rates should be driven up through competition for funds, bringing the expansion to a premature end. The budget proposed by the President plans a substantial diminution of the present large deficit, and thus meets the need to move toward budgetary balance. In terms of the hypothetical budget that would obtain if the economy were operating at full employment, the present substantial deficit is expected to shift, in the course of fiscal year 1977, to a small surplus.

Apart from these comments on the over-all budget stance, I would also like to react to the concept of curtailing budget expenditures and cutting taxes by matching amounts. Even though economists generally maintain that such simultaneous cutbacks on both sides of the budget tend to be dampening rather than neutral with respect to economic activity, this negative effect is minimized in the budget proposals because a substantial portion of the spending restraints occur in the area of transfer payments rather than in that of purchases of goods and services. Restraint on government transfer expenditures is not likely to restrain the expenditures of the beneficiaries by quite the same amount. On the other hand, taxes foregone by the government are not likely to raise taxpayers' spending by a fully equal amount. The effects on over-all activity, of the proposed matching spending and tax cuts, therefore, are likely to be small. Given this, the merits of the proposals need to be judged on grounds of the support they would lend to the long-term strength of our economy rather than on their short-run effects on economic activity.

I now would like to turn to monetary policy. In the present expansion the aims of monetary policy have been to help provide the needed financial support for recovery and to contribute to the rebuilding of liquidity which was essential for the resumption of sustained economic growth. At the same time, monetary policy has sought to avoid actions that could supply the financial tinder for a new burst of inflation. We believe that these have been the appropriate policy objectives and the Board would favor continuing to steer a middle course that seeks to fulfill these principal goals.

Since the spring of last year, as you know, the Federal Reserve has been formulating its policy orientation for a year ahead in terms of ranges for broad monetary aggregates, and has been reporting these to the Banking Committees of each house.

The Federal Reserve has always maintained that targets of this nature must be subject to review and administered with flexibility. At the present time, these considerations are more important than usual due to the difficulty that we have experienced in recent months in interpreting the meaning of the sluggish growth of M_1. The selection of growth rates of monetary aggregates as objectives rests on the presumption of substantial regularities in the holdings of these assets by the public as related to other economic conditions. As Chairman Burns described in his recent testimony, some of the previously reasonably predictable relationships among money supply, GNP and interest rates appear to have changed over the last year. Rapidly spreading new financial practices have led to substantially increased efficiencies in the use of checking accounts and seem to have permitted a very modest expansion in M_1 during the second half of last year to support a large increase in GNP, even while short-term interest rates were declining.

The proper growth path of the monetary aggregates will need to be appraised carefully as the year progresses. Economies in the use of money could spread further this year. But re-establishment of a more traditional relationship between the narrowly defined money supply, GNP and interest rates is also conceivable. In view of these uncertainties, it seems appropriate to give increased emphasis to the broader monetary aggregates as well as to credit conditions in gauging the stance of monetary policy.

In evaluating the current monetary target ranges it is important to note that these ranges are well above the long-run monetary requirements of a noninflationary economy. They are larger because weight has been given to the short-run needs for economic recovery and to the financial demands generated by recent increases in nominal GNP.

A due concern with the long-run outlook requires policy makers to consider also the important decisions that will have to be made with respect to the division of output of our economy between consumption and investment. Specifically, I share the concern, voiced by others, that insufficient resources may be devoted to productive investment in years to come. Further, I believe that Congress, as it decides tax and spending policies, will have an important role in determining whether and how severe a capital shortage may develop.

Several developments would seem to imply enlarged capital needs in coming years. Among them is the need for reduced pollution and for more investment in industrial health and safety. Higher energy prices have made investment in domestic energy production more economically feasible and have provided many incentives for U.S. households and industry to invest in means of economizing on energy usage. Finally and most importantly, the need to provide jobs for a growing labor force will require a considerable expansion of productive capacity. This need for greater capacity was underscored by the bottlenecks encountered in many industries in 1973 and 1974.

The financial and real resources needed to bring about higher rates of private investment in an economy approaching high capacity utilization will have to come from higher rates of saving. It is not certain that private saving will be adequate, particularly if savings rates return to more traditional levels. The Federal Government thus may be called upon to play a vital role in bridging the gap between private saving and desirable levels of investment.

This could be accomplished if the Federal Government were to achieve a surplus in its budget as the economy approaches full employment. A budget surplus is a form of government saving which would make resources available for use in the private sector. With the Federal Government a net supplier of funds to the credit market, rather than a net user, there would be downward pressures on interest rates. More credit would be available to businesses, homeowners, and consumers. The channelling of this increased supply to finance investment would be facilitated by tax devices such as the deferral of the tax on personal income devoted to equity acquisitions proposed by the President that would encourage the issuance of capital stock by corporations.

Long range budgetary policy is then seen to take on added importance. As we leave recession behind us, the full employment status of the budget will be a key determinant of interest rates. It will have a strong impact on the availability of capital to meet our needs. As you review the five-year projection of the budget, I urge you to keep these long-run needs in mind.