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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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Mr. Chairman, members of the Committee, it is a pleasure to meet with you and to report, on behalf of the Board, about the outlook for the national economy and about the course the Federal Reserve has charted for monetary policy over the year ahead. I look forward to a continuing dialogue with you on these matters at this Committee's regular monetary oversight hearings.

· ECONOMIC ACTIVITY IS REBOUNDING

The economy is currently rebounding from a slack period early in the year when economic activity was constrained by severe weather and the long coal strike. Retail sales and industrial production have risen sharply since mid-winter. Auto sales have strengthened. Housing starts increased markedly in March from the relatively depressed levels of January and February.

Employment has grown steadily since the beginning of the year. Although the length of the average workweek declined in the first quarter, the number of people on the nation's payrolls rose substantially between December and March, and the unemployment rate edged down from 6.4 to 6.2 per cent. These favorable trends in the labor market are depicted, along with the behavior of real gross national product, in the attached chart 1. The continuing uptrend in employment suggests that businessmen have had sufficient confidence in the underlying strength of the economy to be positioning themselves for further increases in production.

Looking ahead, growth in economic activity is expected to be sustained over future months by expanding consumer and business demands. As shown in chart 2, the near-term prospects for good gains in consumer spending appear favorable, as indexes of consumer sentiment have remained at high levels.

Business spending also should provide impetus to expansion. Inventories generally remain lean, and businesses are likely to be building their stocks in the next few quarters. Business investment in plant and equipment, after lagging early in the economic upswing, has increased at a good pace over the past two years, as shown in the upper panel of chart 3. Surveys of capital spending plans and other advance indicators suggest at least moderate further growth in the year ahead.

Although State and local governments by and large continue to pursue cautious financial policies, they also may register significant increases in real expenditures in the period ahead. Residential construction should show sizable increases in the next few months before tapering off gradually in the second half of this year. And the foreign trade deficit, while remaining large, should moderate somewhat from the very high first quarter rate.

• BUT INFLATION HAS WORSENED

While the prospects for economic activity thus appear to remain favorable, there are other aspects of recent economic performance that reflect fundamental problems which will not be put behind us quickly. Inflation undoubtedly is the most troubling of these to the American people. Even as growth in real GNP was interrupted in the first quarter, the rate of increase in prices accelerated. Wholesale prices rose at a 9.6 per cent annual rate during the past three months--well above the already uncomfortably high rates experienced last year. Consumer price increases also accelerated. To be sure, a substantial spurt in volatile food prices contributed importantly to the advance in the broad price indexes, but prices of industrial commodities and of services also have continued to rise at a brisk pace. These unfavorable trends in prices are displayed in chart 4.

• • UPWARD COST PRESSURES REMAIN

There is little reason to be optimistic about the likelihood of achieving a significant reduction in underlying inflationary forces in the near future. Cost pressures remain strong. In 1977, for example, total compensation per hour in the private business sector rose almost 9 per cent, while productivity increased only 2½ per cent; as a result, unit labor costs rose more than 6 per cent. There has been no sign of any abatement of the advance in wage rates, and at this stage of economic expansion there is little likelihood of a sustained pick-up in productivity growth. Therefore, rising unit labor costs can be expected to continue to exert considerable upward pressure on prices.

• • GOVERNMENTAL PROGRAMS HAVE ADDED TO COSTS AND INFLATION

Price pressures have been exacerbated by governmental actions. Certain tax actions, while they have helped to reduce the budgetary deficit and in this way have worked to restrain one of the forces feeding inflation, simultaneously have added to labor costs. This has been the case, for instance, with increases in employer contributions for social security and unemployment insurance. Some other governmental actions also have added to inflationary forces without any compensating restraint. In this class are the increase in the minimum wage, agricultural price supports, and various import restrictions. In general, there has been a tendency by government over the years to treat the problems of individual sectors without adequate regard to the cumulative inflationary bias the programs have imparted to the economy.

. . SO TOO HAS THE DECLINING INTERNATIONAL VALUE OF THE DOLLAR

Another disturbing aspect of economic performance in the opening months of this year has been the pronounced widening of the foreign trade deficit and the weakness of the international value of the dollar. As may be seen in chart 5, the estimated trade deficit was greatly enlarged in the first quarter of 1978, as exports remained sluggish and imports in nearly all categories increased sharply. Against this backdrop, the dollar declined on exchange markets, and by the end of March its trade-weighted value against other major currencies was 8½ per cent lower than early last fall. The depreciation of the dollar is tending to raise the domestic price structure in various ways: higher prices of imported finished goods raise directly the prices paid by consumers; higher prices of imported materials raise the costs of domestic manufacturers; and higher prices of foreign goods reduce the pressure to hold down prices of the domestically produced goods with which they compete in our markets.

In recent weeks, the dollar has risen relative to other major currencies. Such a trend, if continued, will help moderate inflationary pressures.

- THE PRESIDENT'S ANTI-INFLATION PROGRAM OFFERS HOPE OF BREAKING INFLATIONARY PSYCHOLOGY

President Carter recently outlined a broad program to help deal with the problem of inflation. The Federal Reserve welcomes this initiative. Given the support of the Congress and of the general public, the program is a constructive step toward breaking the inflationary patterns and psychology that today are so firmly entrenched. The job of containing inflation requires a concerted effort on the part of all Americans. The Federal Reserve will play its part in supporting the President's initiative by exercising appropriate restraint in the provision of bank reserves, credit, and money.

The prospects for inflation will play a major role in shaping future financial developments. The strength of the dollar on foreign exchange markets is influenced by expectations about inflation. So, too, is the level of interest rates in domestic credit markets. The increase in interest rates during the past 12 months--especially the $\frac{1}{2}$ to $\frac{3}{4}$ percentage point increase in long-term bond rates--may be attributable in part to heightened inflationary expectations.

• MONETARY POLICY HAS BEEN ADJUSTED TO RESTRAIN UNDULY RAPID MONETARY GROWTH

Yields on most short-term market instruments today are about 1¾ to 2 percentage points higher than a year ago. This rise occurred gradually as the Federal Reserve adjusted its policies in light of the tendency for monetary expansion to exceed the growth ranges that had been established. The tendency was most pronounced in the case of the narrow money stock, M-1, which includes only currency and demand deposits. Largely as a result of the rapid expansion of M-1, however, growth in the broader monetary aggregates --M-2 and M-3--also remained near the upper ends of their ranges. M-2 is M-1 plus time and savings deposits at commercial banks (other than large negotiable certificates of deposit), while M-3 includes also time and savings deposits at thrift institutions.

For most of the current cyclical expansion, growth in M-1 had been well within the ranges established by the Federal Reserve. Indeed, early in the expansion, growth was near the low end of the range. In part, this was the result of actions by the public to shift funds from demand deposits to interest-bearing savings deposits and market instruments in response to financial innovations that made it easier to transfer funds in and out of savings deposits. In part, it seems to have reflected a lagged response to the unusually high level of interest rates reached during the 1973-74 inflation. And, in part, it may also have reflected the return of confidence during economic recovery, which made the public more willing to spend out of existing cash balances and thus reduced the need for the Federal Reserve to supply additional money to the economy.

By last year, the moderating impact on money growth of such factors had considerably lessened. Moreover, persisting upward cost and price pressures were making it difficult for the Federal Reserve to hold money growth within bounds while not risking undue interference with continued economic expansion. Finally, it is possible that the public earlier had reduced its cash balances to unsustainably low levels relative to income, and that some part of the sizable expansion in money last year reflected a restoration of cash balances to more normal levels.

• MONEY GROWTH HAS SLOWED

Growth in the monetary aggregates slowed during the latter part of 1977 and in the early months of 1978. As can be seen in charts 6 and 7, M-1 has moved back within the FOMC's ranges, while M-2 has moved from the upper limits of the ranges toward the lower limits. M-3 has behaved about the same as M-2. This moderation of monetary expansion has reflected in part the cumulative impact of the restraining actions and rise of short-term interest rates that began in the spring of last year. The influence of interest rates has been most evident in the case of the interest-bearing components of the monetary aggregates. As market rates of interest rose relative to deposit rate ceilings, some savers shifted their funds from deposits at banks and nonbank thrift institutions into market instruments, in the process contributing to the slowing of M-2 and M-3 growth.

• WITH CREDIT DEMANDS STRONG, LIQUIDITY OF BANKS AND THRIFTS HAS COME UNDER PRESSURE

The slowing of monetary expansion in recent months, in conjunction with strong credit demands, has been accompanied by some erosion in the liquidity of depository institutions. To finance business, consumer, and mortgage credit demands, commercial banks have turned increasingly to the short-term credit markets as a source of funds. There has been marked growth in the outstanding volume of large-denomination time deposits, which are not subject to regulatory interest rate ceilings, and in the nondeposit interest-bearing liabilities of banks. At the same time, banks have appreciably reduced their holdings of Treasury securities. Despite these changes in bank portfolios, however, customary measures of bank liquidity still indicate more comfortable conditions than prevailed a few years ago.

Thrift institutions, with the exception of credit unions, have experienced much the same pressures as commercial banks, as mortgage loan demand has remained strong. To accommodate that demand, institutions--in particular, savings and loan associations, which are the largest home mortgage lenders--have borrowed heavily from Federal Home Loan Banks and curtailed their acquisitions of securities.

The S&L's have also utilized other sources of funds, including the growing markets for private mortgage-backed bonds and mortgage pass-through securities to sustain new mortgage lending. These markets promise ultimately to give thrift institutions greater flexibility in managing their portfolios, and to make the residential mortgage market less dependent on thrift institutions' deposit flows. At present, however, with deposit flows running weaker and liquidity coming under pressure, S&L's have cut back on the outstanding volume of loan commitments since year-end. And mortgage interest rates have risen moderately in recent months.

- CREDIT REMAINS GENERALLY AMPLE, HOWEVER

Despite the greater pressures experienced by depository institutions, credit generally remains in ample supply. Borrowers are experiencing little difficulty in raising needed funds at current interest rate levels. And while higher than a year ago, interest rates are at relatively modest levels after allowance is made for the effect of inflation.

- MONETARY GROWTH RANGES FOR YEAR AHEAD ARE EXPECTED TO SUPPORT FURTHER ECONOMIC EXPANSION AND A LOWER UNEMPLOYMENT RATE, BUT INFLATION MAY NOT DECELERATE UNTIL LATER

The ranges of monetary expansion adopted by the Federal Open Market Committee for the year ending with the first quarter of 1979 reflect our belief that growth in the monetary aggregates should be moderate, with credit remaining in reasonably good supply. The Committee has specified a growth range for M-1 of 4 to 6½ per cent. For M-2, the range selected is 6½ to 9 per cent, and for M-3, 7½ to 10 per cent. These ranges are the same as the Committee had earlier specified for the year ending with the fourth quarter of 1978. Although the FOMC at this time has not made a further reduction in its monetary growth ranges, the Committee remains firmly committed to a gradual reduction in monetary growth over time to rates more nearly consistent with reasonable price stability. The ranges just adopted in fact contemplate that actual monetary growth in 1978 and into early 1979 will be slower than last year. Because there have been signs of a resurgence in M-1 growth over the last few weeks, the Federal Reserve has recently been less accommodative in supplying reserves in order to keep monetary growth within reasonable bounds over the long run. The money market in consequence has tightened a bit over the past few days.

In addition to adopting ranges for the monetary aggregates, the FOMC also adopted an associated range for bank credit that projects an increase between 7½ and 10½ per cent over the one-year period ahead. Such a range would allow for continued expansion in bank credit at around its recent pace.

It was the consensus of the Federal Open Market Committee that expansion of monetary and credit aggregates within these ranges would be consistent with moderate growth in real GNP over the coming year and with some further decline in the unemployment rate. However, upward price pressures remain strong, and the rate of increase in the average price level, therefore, might be somewhat more rapid over the year ahead than it was in 1977. Full and effective public support of the Administration's anti-inflation program, and success in keeping the budget deficit under control, would aid in restraining upward pressure on prices and would help create conditions whereby we could look forward to a gradual deceleration of the inflationary process.

Let me supplement this with my own views about the outlook for the economy in quantitative terms. My personal expectation is that, over the year ending with the first quarter of 1979, real GNP probably will increase in a $4\frac{1}{4}$ to 5 per cent range, the unemployment rate probably will drop into the $5\frac{3}{4}$ to 6 per cent area, and the GNP price deflator is likely to rise by $6\frac{3}{4}$ to $7\frac{1}{4}$ per cent. It is hardly necessary to add that quantitative projections, such as these, are subject to considerable margins of uncertainty. Necessarily they have to be re-evaluated on the basis of incoming economic data and changing conditions here and abroad.

Specifying growth rates for the monetary aggregates, too, is subject to considerable uncertainty. The growth in the narrowly defined money supply (M-1) needed to support economic expansion depends in part on changes in the velocity of money--that is, on the rate at which the public uses the existing stock of money to finance transactions. Velocity may rise rapidly or slowly, depending on shifting public preferences for demand deposits as compared with other assets and on the state of consumer and business confidence.

The behavior of the broader aggregates--M-2 and M-3--will be affected in the year ahead also by the constraint placed on the ability of depository institutions to attract funds under existing regulatory ceilings on deposit rates. If heavy demands for money and credit should place further upward pressure on market interest rates, deposits subject to regulatory rate ceilings will be placed at a substantial competitive disadvantage. In such a circumstance, growth of M-2 and M-3 could fall short of the ranges set by the FOMC, unless there are upward adjustments in the ceiling rates on some or all categories of time and savings deposits.

- FEDERAL RESERVE SHOULD NOT BE LEFT TO COMBAT INFLATION ALONE. EFFECTIVE ANTI-INFLATION PROGRAM REQUIRES CO-OPERATIVE EFFORT

The Federal Reserve believes that its determination to hold monetary growth within the ranges just adopted will work to curb inflation over the longer run and at the same time provide adequate money and credit for continued economic growth. However, under current conditions--when inflationary pressures are to a great extent embodied in the structure of the economy--any deceleration in monetary growth rates has to be undertaken with caution. The pace of deceleration cannot proceed much more rapidly than the pace at which built-in inflationary pressures are wrung out of the economy if satisfactory economic growth is to be maintained. Thus, bringing inflation under control urgently requires the co-operative efforts of the Administration, the Congress, the Federal Reserve, and the private sectors of the economy. The Federal Reserve should not be left to combat inflation alone.

Chart 1

OUTPUT, EMPLOYMENT, AND UNEMPLOYMENT

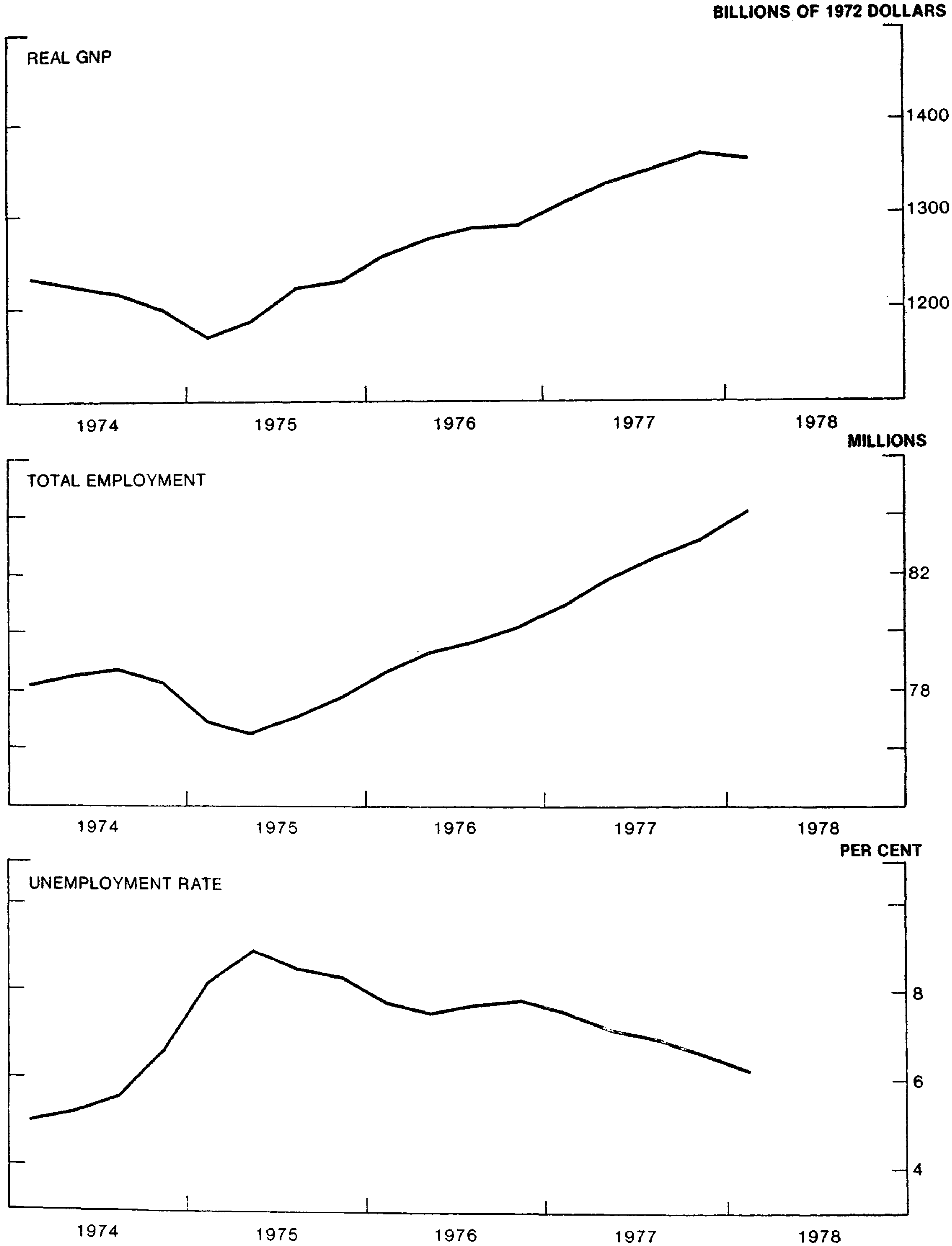
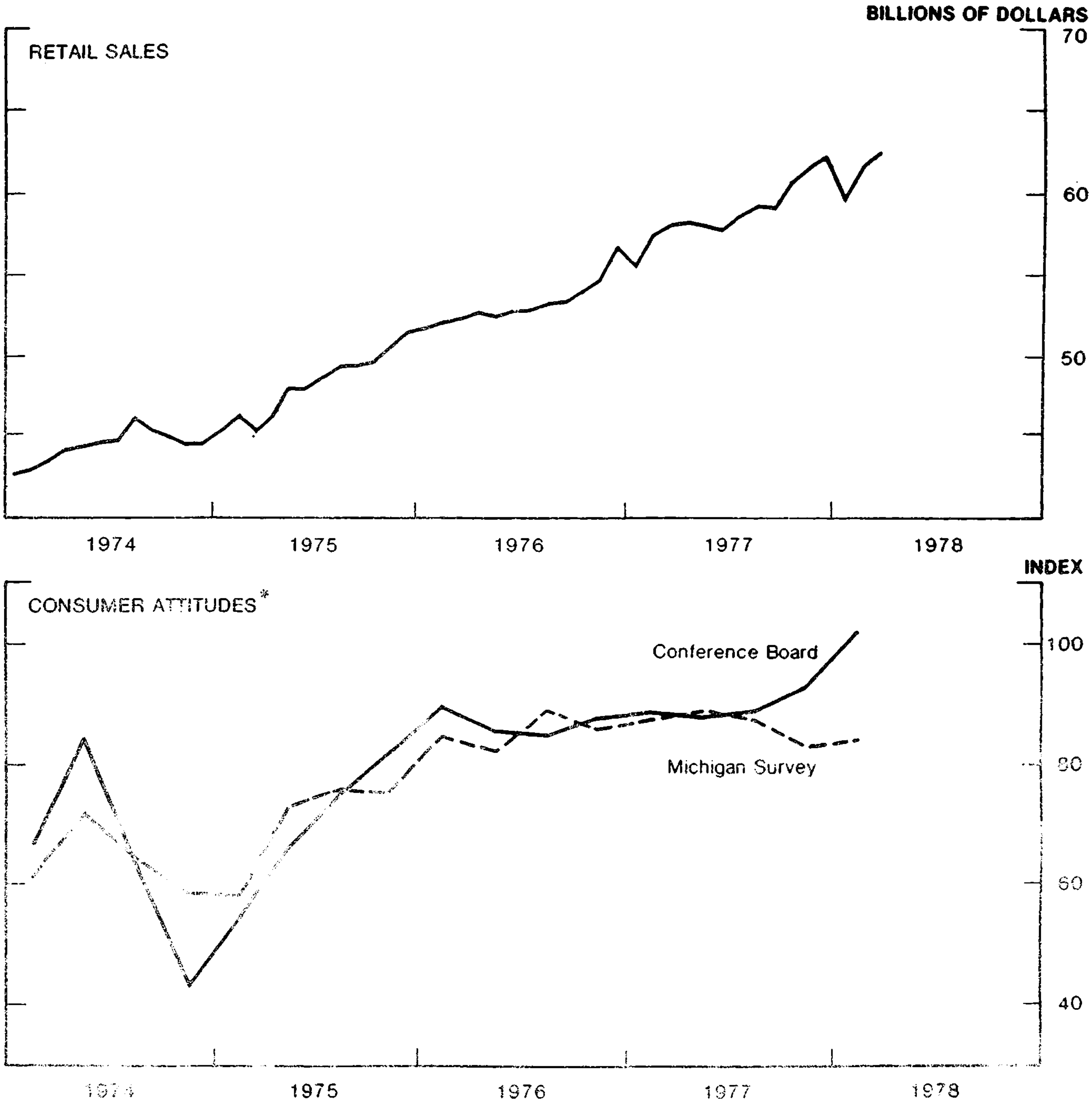


Chart 2

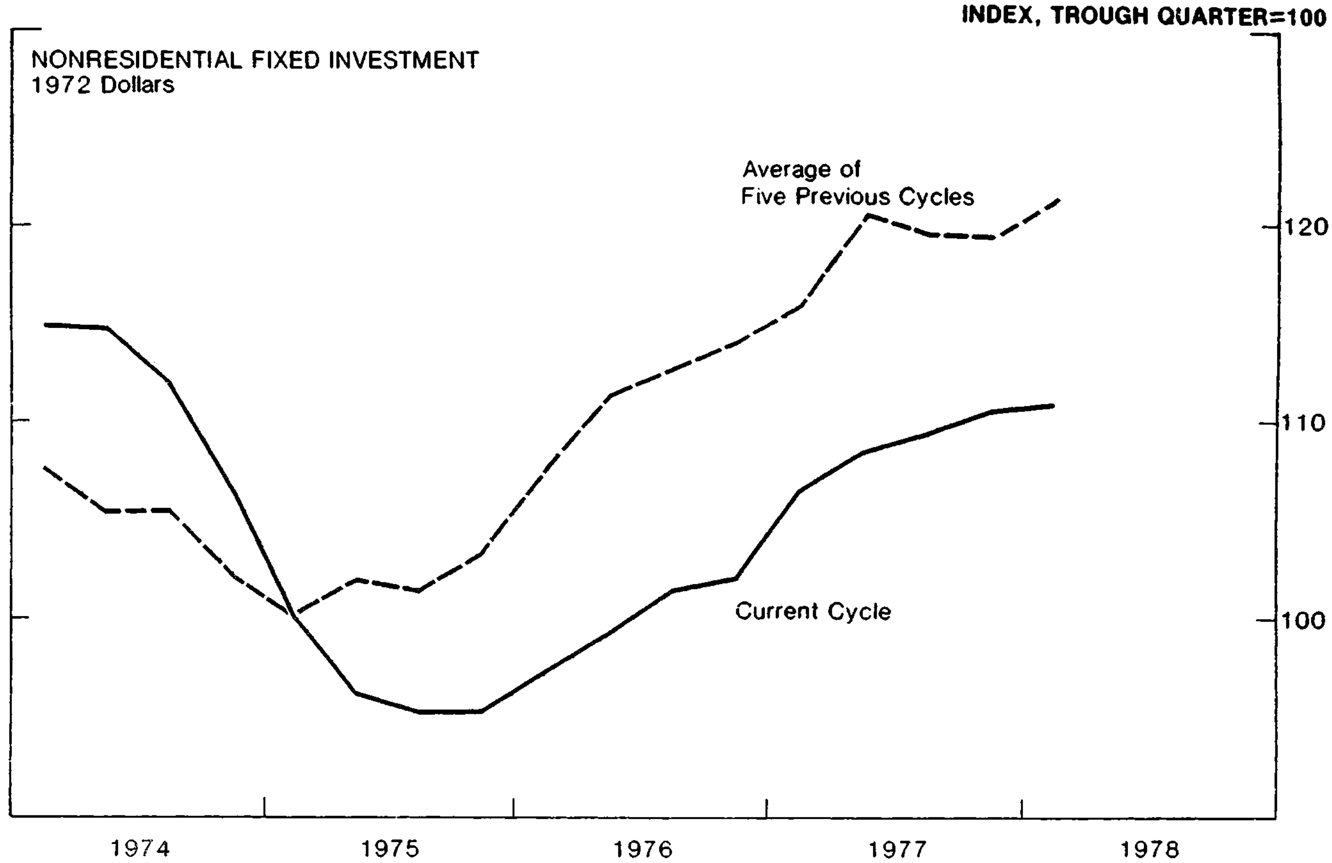
CONSUMER SECTOR ACTIVITY



* Conference Board index of consumer confidence, 1969-70 = 100.
Michigan survey index of consumer sentiment, 1966 QI=100.

Chart 3

BUSINESS CAPITAL SPENDING ACTIVITY



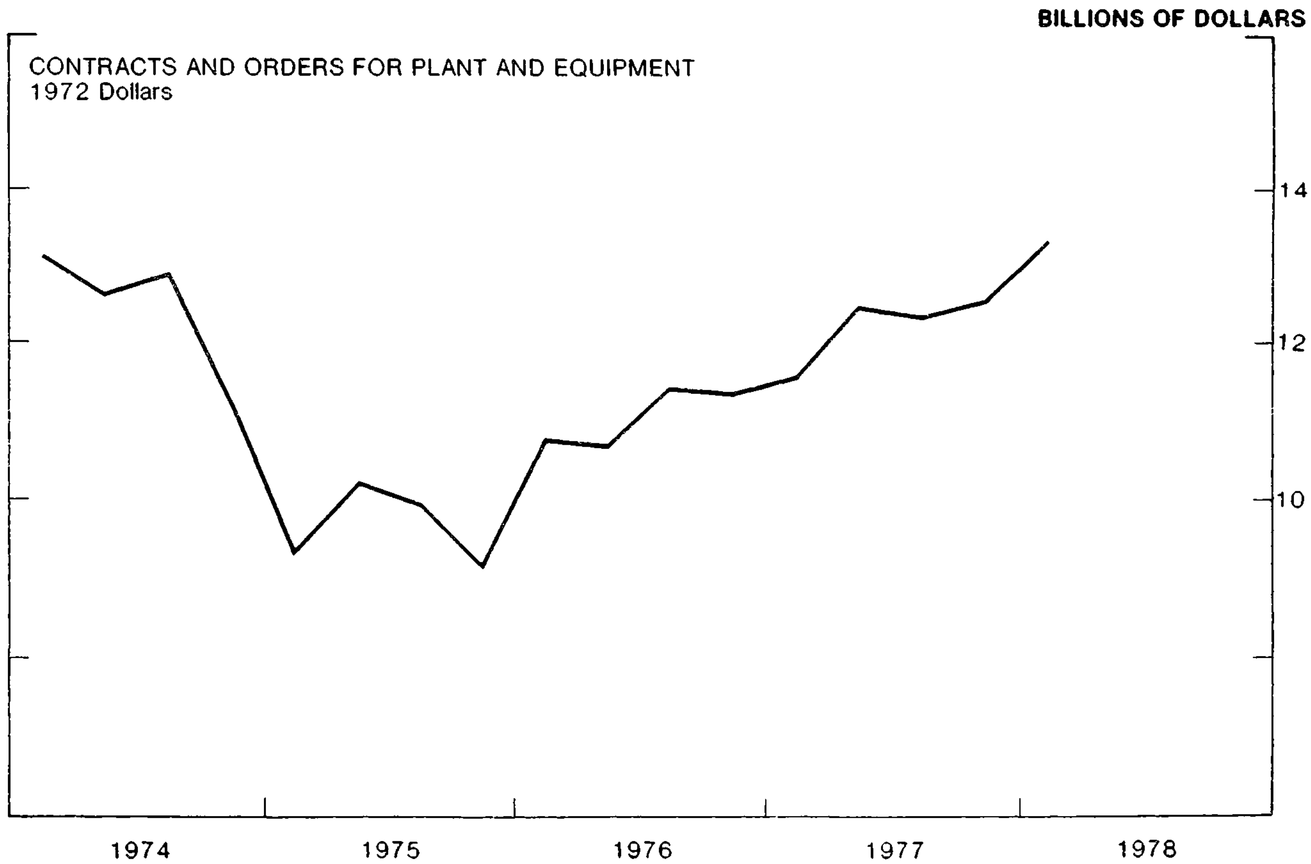


Chart 4

MEASURES OF AGGREGATE INFLATION

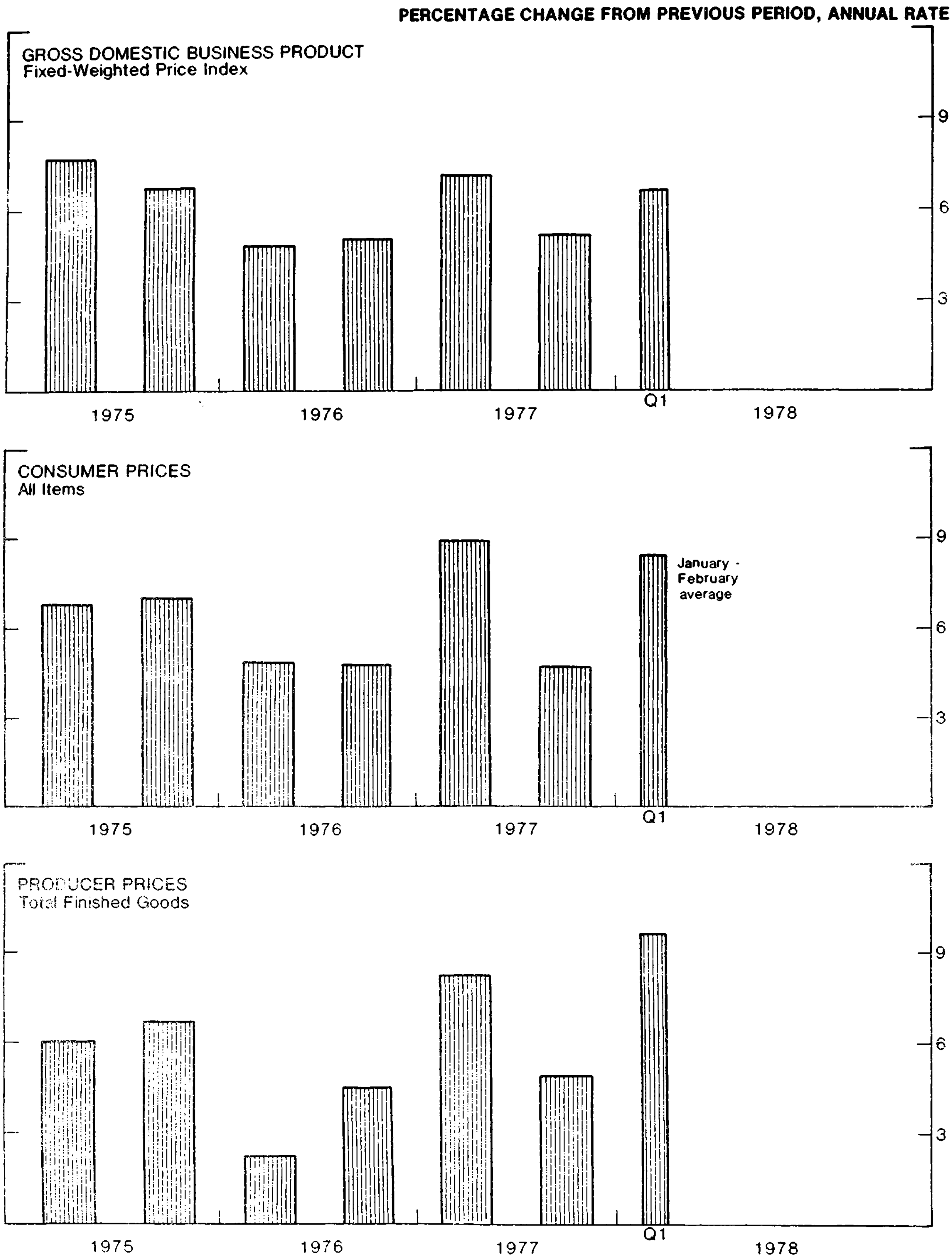
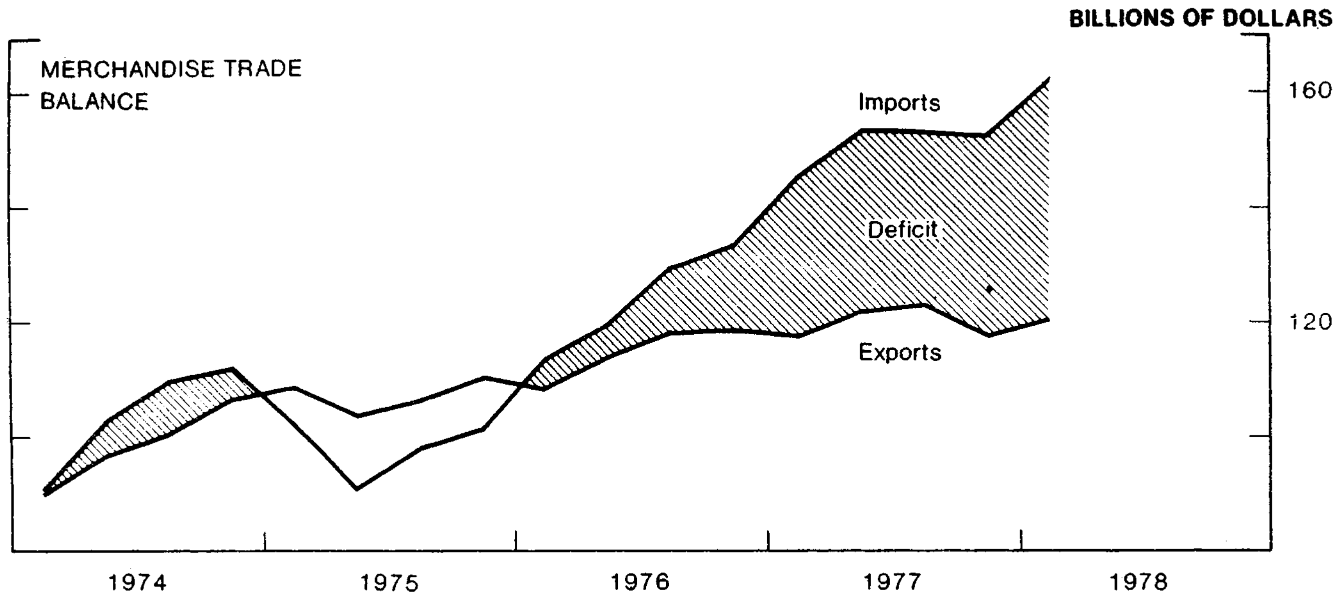
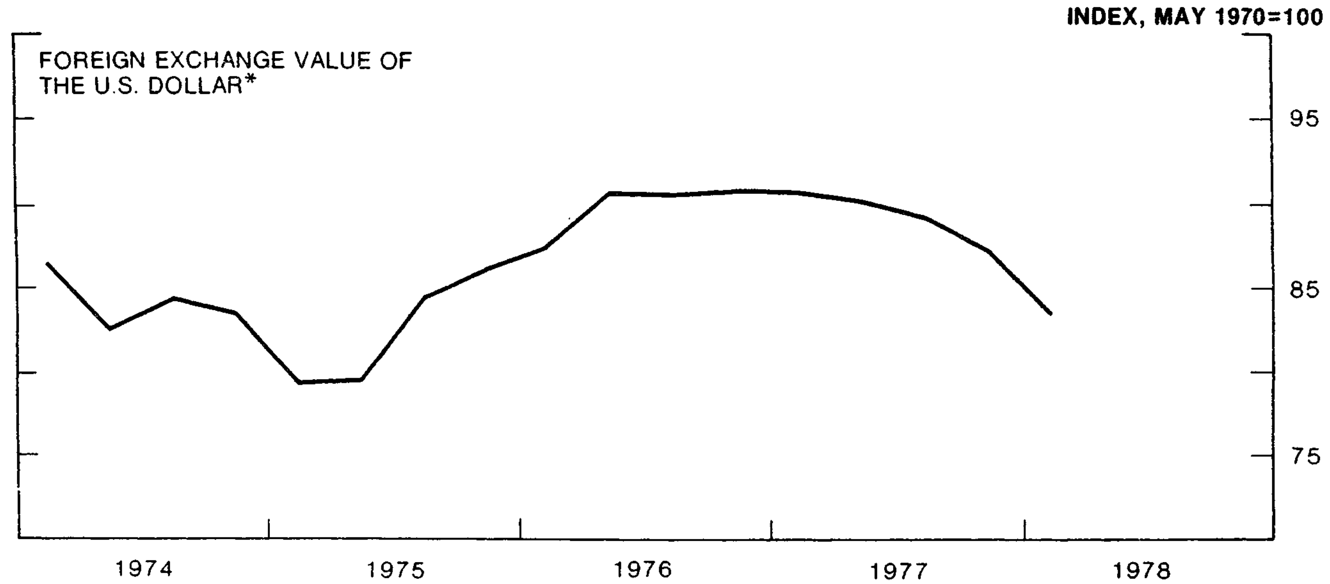


Chart 5

INTERNATIONAL SECTOR ACTIVITY





*Weighted average against G-10 countries plus Switzerland using total 1972 trade of these countries.

Chart 6

RECENTLY ESTABLISHED M-1 GROWTH RANGES AND ACTUAL M-1

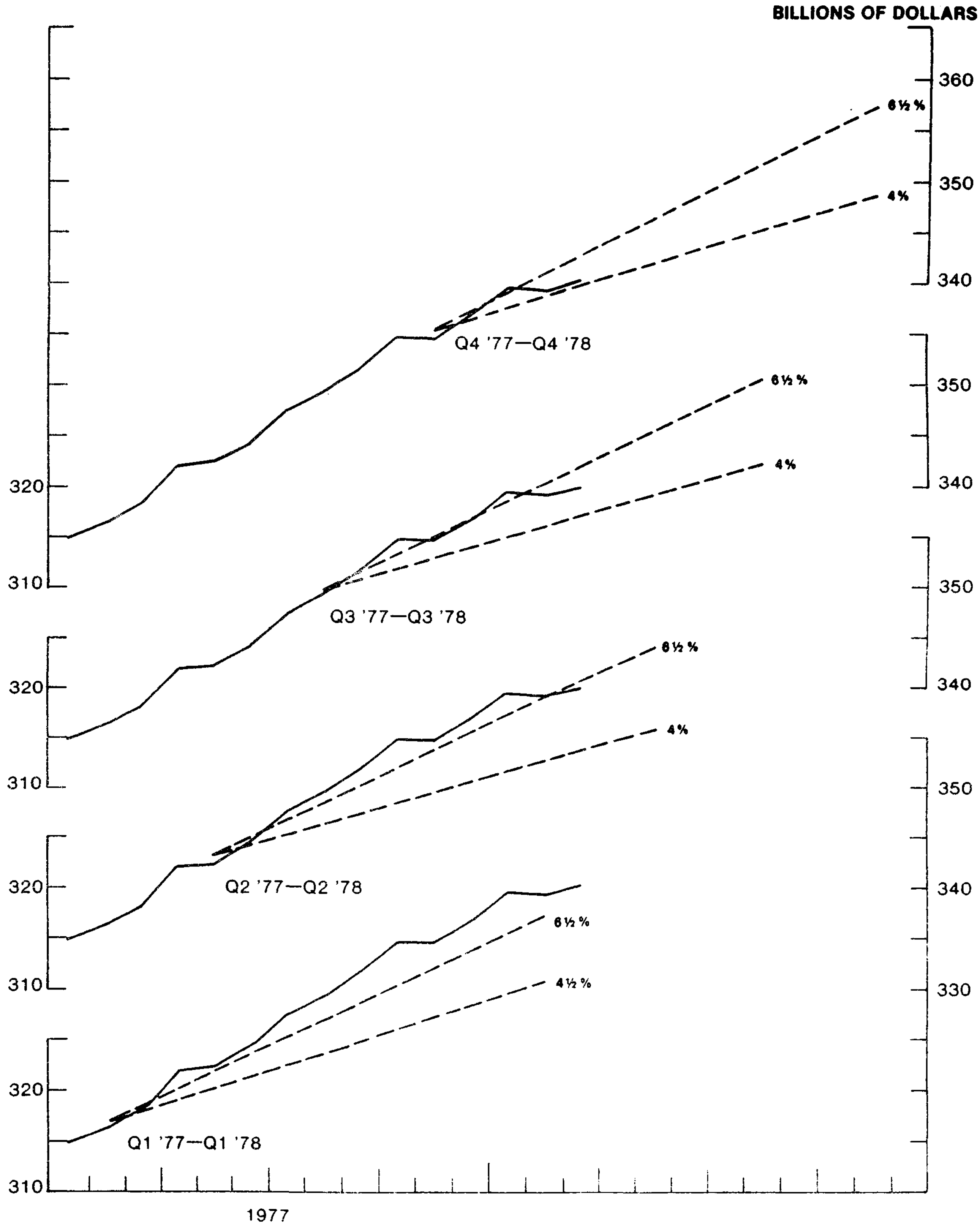


Chart 7

RECENTLY ESTABLISHED M-2 GROWTH RANGES AND ACTUAL M-2