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SEMI-ANNUAL REPORT ON MONETARY POLICY

Statement by

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before the

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Mr. Chairman, members of this distinguished Committee, events in recent months have presented a formidable challenge to our nation. While sustained economic expansion has led to higher levels of output and employment, continuing domestic inflation and a sharp decline in the value of the dollar on foreign exchange markets have posed growing threats to the vitality of the U.S. and world economies. Monetary policy is being directed forcefully toward helping to resolve these urgent problems.

The objective of the Federal Reserve has, for some time now, been to foster monetary and financial conditions that would lead to a reduction of inflationary pressures, while encouraging continued moderate economic growth. Real gross national product rose at a 4 per cent annual rate, on average, during the first three quarters of this year, as compared with 5-1/2 per cent over the course of 1977. This slower pace in the expansion has been sufficient to achieve substantial further gains in employment, but at the same time it has avoided a significant overshoot of general levels of resource utilization that would have intensified inflationary demand pressures in labor and product markets.

Even so, there has been a marked pick-up in the rate of inflation. For example, consumer prices have climbed at an annual rate of 9-1/2 per cent so far this year. A number of factors have contributed to this development. Reduced supplies of some agricultural commodities--

especially meats--have caused sharply higher food prices. Legislated increases in the Federal minimum wage and in employer contributions for social security and unemployment compensation have boosted labor costs. Wage gains have been somewhat larger this year than last, on average, while our productivity performance has been lagging. And the depreciation of the dollar in international exchange has raised the prices of imports and weakened competitive restraints on the prices of domestically produced goods.

With a heavy calendar of collective bargaining in prospect for 1979, and with wage demands likely to be intensified by recent price advances, the threat of a further escalation of labor costs is very real. Furthermore, scheduled increases next year in the minimum wage and social security taxes will again provide a significant inflationary impulse to costs.

President Carter has announced a major program to break the self-destructive cycle of wages chasing prices and prices chasing wages. The program includes quantitative guidelines that establish standards for constructive behavior on the parts of labor and management. In addition, the President has indicated that he will seek to eliminate needlessly costly and anti-competitive regulation. He has also committed his Administration to the containment of Federal spending and greater fiscal restraint.

On November 1, the Administration's anti-inflation program was fortified by the joint actions of the Federal Reserve and Treasury to strengthen the dollar in exchange markets. The Federal Reserve discount rate was raised by one percentage point, and reserve requirements on large denomination time deposits were increased. In addition, $30 billion in key foreign currencies were mobilized for exchange market intervention. The speculative assault on the dollar in international currency markets had depressed its exchange value well below what could be justified on the basis of fundamental economic considerations. The psychological momentum of the markets, if not broken, threatened to worsen our inflation problem and to undermine confidence at home and abroad. The clear willingness of the United States to intervene actively in exchange markets and the monetary actions of the Federal Reserve have led to a rebound in the exchange value of the dollar and a more stable market environment. This should be beneficial for domestic price performance in the period ahead and bolster confidence in the nation's economic policies.

If the cooperation of business and labor that is so essential to the success of the Administration's anti-inflation program is to be obtained and if we are to gain the fullest benefit of the recent dollar-support initiatives, it is absolutely essential that monetary and fiscal policies demonstrate prudent restraint. If inflation is to be gradually slowed, aggregate demand must not be permitted to expand to the point where it presses excessively on available supplies of labor and industrial resources. This means that real GNP at this juncture probably should not grow at an annualized rate much above 3 per cent, in line with the prospective growth of potential output. Nor, of course, do we want to see a protracted shortfall from that pace that would bring on recession and underutilization of labor and productive capacity.

Recent trends in the economy and in financial markets suggest that expansion likely will be sustained, but at a more moderate pace over the next year or so. One noteworthy development has been the less robust pattern of spending by households following exceptional strength earlier in the cyclical recovery. Personal consumption expenditures rose at an estimated annual rate of less than 3 per cent in real terms during the first three quarters of this year, after having advanced at an average rate of 5-1/2 per cent in the preceding 2-3/4 years. Rising costs of foods and other necessities have put substantial pressure on the budgets of many families, and the proportion of disposable income spent has been unusually high. Record levels of borrowing have played an important role in supporting consumer outlays, and the heavy repayment burdens households face are likely to be an increasing constraint on spending in the forthcoming year. As a consequence, personal consumption expenditures probably will no more than keep pace with increases in personal income.

In addition, financial factors should induce some tapering off in homebuilding in 1979. To date housing starts have remained on a high plateau, but the effects of recent increases in interest rates will soon begin to show through. The new 6-month certificates, introduced in June, have enabled thrift institutions to avoid the disintermediation that has curtailed mortgage credit availability in the past, but they have not sheltered the housing market from the effects of higher interest rates. Builders already are experiencing steeper rates on construction loans, for which charges tend to move in step with the bank prime business loan rate, and the stock of loan commitments for permanent mortgage financing made earlier at lower rates is being depleted. The combined effects of higher mortgage rates and inflated house prices on the cost of home ownership is likely to bring about some decline in building--although nothing approaching the disastrous drops we've seen in the past seems in store.

Business investment meanwhile should remain supportive of economic expansion. Inventories by and large are quite lean in relation to current sales levels, and even with a continuation of cautious inventory policies, businessmen likely will wish to expand their stocks in line with rising sales. As for spending on plant and equipment, a recent private survey of investment intentions suggests only a modest increase next year in real terms. On the other hand, contracts and orders for new plant and equipment have been running well ahead of year-earlier levels--even after adjustment for inflation. In general, the willingness of businessmen to commit funds for major investment projects will hinge in large part on the success of efforts to control inflation, and thereby provide the basis for greater confidence in the future health of the economy.

The foreign trade sector represents an element of strength in the economic outlook. The U.S. trade deficit should continue to shrink as a result of the stronger growth in prospect for some of our major trading partners and as a result of the effects of past exchange rate changes on our competitive position.

In all, it is my expectation that real GNP will increase by roughly 2-1/2 to 3 per cent in the year ending with the third quarter of 1979. With labor force growth unlikely to be so rapid as in the past couple of years, this rise in activity should be enough to keep the unemployment rate in the 5-3/4 to 6-1/4 per cent area.

In this projection I have assumed that inflation will slow into the 6-3/4 to 7-1/2 per cent range. There are as always many uncertainties on the price front--the effects of weather on crop harvests and the decisions of the OPEC cartel, for example, are factors beyond the sphere of economic analysis. What is clear is that the cost increases already in train will be placing continued pressure on the price structure, so that it will be difficult to break the momentum of inflation. However, if there is general compliance with the Administration's guidelines, the advance of prices next year could be held to around the low end of the range I've projected. This would represent a substantial deceleration from the 8-1/4 per cent increase in the GNP deflator expected for this year, and would be a good start in the difficult process of restoring price stability.

The recent credit-restraining actions of the Federal Reserve have aroused fears in some quarters that an overly restrictive monetary policy might precipitate an economic downturn. There is no doubt that domestic credit markets are tauter than they were 6 months ago. Nonetheless, current financial conditions appear consistent with the moderate economic expansion that is desirable at this juncture.

The Federal Reserve has been moving its policies in a progressively less accommodative direction this year in an effort to prevent excessively rapid growth in money and credit. In an environment of inflation and heightened inflationary expectations, borrowers have become willing to pay higher rates of interest in order to obtain credit to finance acquisition of assets whose values they anticipate will be rising more rapidly. This phenomenon is most clearly seen in the real estate market, but the behavior is common in other sectors as well. To hold down nominal rates of interest in such a circumstance is to invite a credit-financed surge in aggregate demand that would add further to inflationary pressures. Consequently, the Federal Reserve has pursued policies that have permitted market rates to rise appreciably this year. Yields on Federal funds and other short-term instruments have increased more than 3 percentage points since the beginning of 1978, while interest rates on long-term bonds and mortgages have risen about one percentage point.

These are sizable movements, to be sure, but the fact is that, even at current levels, real rates of interest--that is, actual rates adjusted for inflationary expectations--are not very high and credit remains in adequate supply to finance a volume of spending that is appropriate in light of the availability of real resources in the economy. Usury ceilings, which are unrealistic in relation to present market interest rates in many states, are cutting into credit availability in some local markets, and it would be desirable if these obstacles to the efficient operation of our financial system were eliminated. But there has been nothing like a general "credit crunch," and we do not foresee one.

It is the intention of the Federal Reserve to work toward a gradual deceleration of monetary and credit expansion to a pace consistent with price stability. The speed with which we can move in that direction without severely disrupting economic activity is limited by the degree to which inflation has become embedded in our economy. But some progress has been made in the past year. While M-1 growth over the past four quarters--at 8 per cent--was about the same as in the previous year, growth in M-2 and M-3 decelerated to rates of 8-1/4 and 9-1/4 per cent, respectively. Growth in these broader aggregates was 3 to 3-1/2 percentage points slower than in the previous year. The actual growth in M-1 over the past four quarters was well above the 4 to 6-1/2 per cent range set for this aggregate, but growth in the broader aggregates was within their ranges. To have achieved significantly lower growth rates for the monetary aggregates than actually developed would have required substantially higher market rates of interest and a sharper curtailment in credit supply, which in our judgment would have run an unacceptably high risk of wrenching financial markets so severely as to lead to an economic recession.

Growth in the monetary aggregates has to be evaluated in relation to basic economic and financial forces affecting the public's preferences for money in its various forms. During the past four quarters growth in nominal GNP remained very rapid as moderate expansion in real output was accompanied by an accelerated rate of price increase, generating a substantial demand for money--particularly M-1--to finance transactions. Federal Reserve policy did not fully accommodate these strong demands, and, in fact, the rate of growth in real money balances actually slowed.

The pattern of growth in the broader aggregates has been strongly influenced by the introduction at banks and thrift institutions in June of this year of the 6-month money market certificate whose ceiling varies weekly with changes in the auction yield on 6-month Treasury bills. Growth in savings and small-denomination time deposits subject to Federally regulated interest-rate ceilings had slowed markedly in the fall of 1977 and in the first half of this year as higher yields on market securities increasingly attracted funds that would otherwise have been held in accounts at banks or thrift institutions. In order to enable these institutions to compete more effectively for lendable funds, the Federal Reserve and other regulatory agencies created two new deposit categories--an 8 per cent, 8 year certificate and the money market certificate.

The money market certificates have proven especially successful. They have been widely offered, most frequently at the ceiling rates, and have resulted in a marked pick-up in consumer-type deposit growth. Growth in deposits at savings and loan associations and mutual savings banks, which averaged 6-3/4 per cent at an annual rate in the first 5 months of 1978, has averaged 13 per cent since the introduction of the new accounts. This growth has permitted thrift institutions to increase their commitments for mortgage loans while reducing their dependence on borrowed funds and stemming the decline in their liquidity positions. At commercial banks, which are at a quarter percentage point rate disadvantage relative to the thrift institutions, there has been a less marked, but still noticeable gain in growth of the combined total of savings and small time deposits--from 3-3/4 per cent through May, to 6-1/2 per cent in the past 5 months. Nonetheless, with bank credit demands remaining strong, banks continued to liquidate Treasury securities and to increase short-term borrowings through such instruments as large CD's and Federal funds in financing these demands.

At its October meeting, the FOMC updated its longer-term ranges for the monetary aggregates. Its task was complicated by new uncertainties associated with the introduction on November 1 of automatic transfer services (ATS) which permit consumers to authorize their banks to shift funds from savings to demand deposit accounts as needed to cover checks written. The major impact of this innovation should be on M-1, as consumers take advantage of the opportunity to reduce their holdings of non-earning demand deposits, but the size of this effect cannot be projected with any real precision. M-2 and M-3 will be less affected because shifts of funds from thrift institutions to banks, and also from market instruments to deposits, are likely to be comparatively modest.

Against that background, the continuity in the FOMC's objectives with respect to the monetary aggregates for the one-year period from QIII:1978 to QIII:1979 is more clearly indicated by the broader aggregates M-2 and M-3. The Committee re-established the ranges for these two aggregates at 6-1/2 to 9 per cent and 7-1/2 to 10 per cent, respectively. It is expected that growth in these aggregates will be well within these ranges as monetary policy pursues a course of responsible restraint to complement the Administration's program to combat inflation through fiscal discipline, wage and price moderation, and regulatory reform. The Committee anticipates growth in bank credit at an 8-1/2 to 11-1/2 per cent rate to be associated with the ranges adopted for the monetary aggregates. With regard to M-1, the FOMC expects growth within a range of 2 to 6 per cent over the QIII:1978 to QIII:1979 period. The existing 4 to 6-1/2 per cent range has been lowered because the public can be expected to shift funds to take advantage of the ATS service, and the range has been widened because of uncertainties about the speed and extent to which the public may undertake such shifts.

Because of uncertainties about the relationship between M-1 and the transactions demand for money during the transition to the new ATS service, and in view of the widening role in financing transactions played by savings accounts, the Committee also indicated a growth range for M-1+ (M-1 plus savings accounts at commercial banks, NOW accounts, demand deposits at mutual savings banks, and credit union share drafts) that it expected to be generally consistent with ranges of growth in the other aggregates. This range has been set at 5 to 7-1/2 per cent over the one year period ending in QIII:1979.

The structure of the domestic payments system has been changing considerably over the past several years as a result of regulatory changes and financial innovations. Deposits in thrift institutions have been increasingly used for third-party payments. At banks, liquidity reserves of the public, as well as funds held against expected transactions needs, have come to be held more and more outside of demand accounts. On the other hand, banks and particularly thrift institutions have also lengthened the maturity of consumer-type time deposit liabilities, so that some deposits have become less money-like. And, in general, distinctions among depository institutions with respect to their deposits have become increasingly blurred. Existing measures of the monetary aggregates are, as a result, becoming outdated. The Federal Reserve is studying possible adjustments to these measures to reflect the changing institutional environment. The measure of M-1+ represents an interim step in this process, while a more comprehensive revision is underway. It should be noted that one consequence of these ongoing changes is a need for more timely and broader reporting of deposit data--not only from nonmember commercial banks, but also from thrift institutions.

While monetary aggregates are useful indicators of financial conditions, the continuing change in the institutional environment and in public preferences for different deposits indicates that any single monetary measure, or even a set of several measures, can by no means be the sole focus of policy. Thus, a broad range of financial indicators--including nominal and real interest rates, credit flows, and liquidity conditions--necessarily must be considered in assessing the stance of monetary policy.

Looking beyond these relatively technical questions about how best to characterize monetary policy, it is clear that in the present environment we cannot rely solely on monetary management to contain inflationary pressures. It is essential to obtain public cooperation in the Administration's anti-inflationary program and to exercise restraint in fiscal policy, if the nation is to achieve a gradual, orderly reduction in the rate of inflation. You can be assured that monetary policy will do its part in achieving that objective.