For release on delivery
10:00 a.m. E.S.T.

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

December 15, 1978

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Mr. Chairman, members of this Committee, thank you for the opportunity to participate in this important dialogue. At present, the economy is at a critical juncture. Economic growth has continued at a moderate pace, but the rate of inflation is unacceptably high and poses an ever-growing threat to our social and economic structure. While the challenge for public policy is clearly formidable, these problems are not insurmountable. The Federal Reserve, for its part, is continuing to pursue a monetary policy that aims at a reduction of inflationary pressures while encouraging continued economic growth and high levels of employment.

The rise in economic activity has been both vigorous and generally well balanced since the present expansion began in early 1975. The sharp swings in inventories and production that have ended previous cyclical upswings have been avoided. Growth in the latter part of this year--well into the fourth year of expansion--has moderated, but this represents a desirable adjustment in the pace of activity, given the intensification of inflationary pressures, the rise in capacity use, and the decline in unemployment that has occurred over the expansion period.

The persistence and recent intensification of high inflation has been the most serious problem in the present expansion. Consumer price increases generally remained in the 6-1/2 per cent range over the 1975-77 period, but these prices have risen at a 9-1/2 per cent

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pace thus far this year. Some of this acceleration can be attributed to weather-related disturbances and to unexpected developments in the farm sector. Labor cost pressures also have played an important role as wage gains have moved up to about 8-1/2 per cent during a period when productivity growth has slowed to a virtual standstill. At the same time, Government-mandated increases in the minimum wage and in payments for social security and unemployment insurance have added a further premium to labor compensation. Finally, the cumulative depreciation of the dollar's foreign exchange value has had an adverse impact on domestic prices that has yet to run its course.

Looking ahead, there is a threat that wage demands could be further escalated, especially with a heavy collective bargaining calendar for 1979 in an environment where inflationary expectations are intense. Cost pressures are also likely to be further exacerbated by another round of legislated increases in payroll taxes and the minimum wage. However, the Government's over-all anti-inflation program holds out the real hope that inflationary pressures can be contained, and that the groundwork can be laid for gradual attainment of price stability. The success of the program requires cooperation, perseverance, and patience from all groups of our society. An important new ingredient of the program is the quantitative standards. If adhered to, these standards could very well help unwind the intractable spiral of wages and prices. But it is particularly important that the program recognizes that Government actions can, in themselves, be important sources of inflation; consequently, fiscal restraint and regulatory reform are essential components of this comprehensive set of proposals.

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Inflation in the United States not only has eroded the value of the dollar domestically, but has also been associated with a decline in its international value. As the exchange value of the dollar dropped, this in turn adversely affected the domestic price level. It raised the cost of imported goods, and also resulted in a further ratcheting up of domestic prices for those goods competing with imports. While the dramatic drop of late October underscored the problem of deteriorating international confidence in the value of the dollar, the period of decline in this current episode dates back to late September of 1977.

From that date to its low in late October of this year, the dollar's exchange value declined by 21 per cent on a weighted average basis against the currencies of the G-10 countries and Switzerland. Against some individual currencies, of course, the decline was even greater, amounting to 26 per cent against the German mark, 34 per cent against the Japanese yen, and 38 per cent against the Swiss franc. Since important external imbalances between the United States and major foreign countries have existed for several years--most notably differential growth and, more recently, disparate inflation trends--some depreciation of the dollar could be viewed as a necessary correction. However, by mid-summer it was clear that the dollar's decline was continuing in trading that was increasingly disorderly. Consequently, in August the Federal Reserve announced a half point increase in the discount rate and an elimination of reserve requirements on Euro-dollar borrowings. At the same time, the Treasury indicated that it would increase and extend its regular monthly gold auctions.

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These measures, which produced a brief rally and then a few weeks of stability for the dollar, were followed by another three-quarter percentage point rise in the discount rate between mid-September and mid-October. But the dollar's slide soon resumed, and it dropped alarmingly to a level well below that warranted by basic economic considerations. As a result, the severity of this latest decline threatened to undercut the anti-inflation program at home and lead to an even greater erosion of confidence abroad.

Under these circumstances, more forceful action was clearly necessary. Accordingly, on November 1 the Federal Reserve increased the discount rate by 1 percentage point and imposed a 2 per cent supplementary reserve requirement on large time deposits. In addition, the Federal Open Market Committee voted to take further actions to tighten conditions in the money market and thereby resist excessive expansion of money and credit. Furthermore, in order to provide a substantial increase in foreign exchange available to finance exchange market intervention, swap lines were increased with the central banks of Germany, Japan, and Switzerland by a total of $7.6 billion. The U.S. Treasury simultaneously announced its intention to draw a portion of the U.S. reserve position in the IMF, to sell SDR's, and to issue foreign currency denominated securities. Over-all, $30 billion in key foreign currencies was mobilized by the United States for forceful, coordinated intervention to support the dollar in foreign exchange markets. In addition, the Treasury announced a further step-up in its rate of gold sales.

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The objective of this coordinated set of measures was to correct the excessive depreciation of the dollar as part of the governmental effort to reduce upward pressures on domestic prices and to restore confidence at home and abroad. When viewed in its entirety, the policy initiatives of the Administration and the Federal Reserve provide a clear message that U.S. economic policy is one that recognizes fully the need for an integrated approach in dealing with foreign and and domestic economic problems.

The measures taken on November 1 produced a dramatic jump in the dollar's exchange value. On that day alone the dollar advanced by 5 per cent on a weighted average basis, and by about the same amount against the mark, yen, and Swiss franc. Substantial cooperative central bank intervention over the following few weeks provided support for the dollar as market participants tested the authorities' resolve. The strength of the dollar generally has been sustained as the market appears to have adjusted to a more favorable outlook generated by the recent policy measures.

To date, the observable repercussions in domestic capital markets also have been generally favorable. In the stock market, most composite share price measures are up from the November 1 announcement date following relatively sharp declines in the preceding two weeks. Short-term interest rates have moved as much as 1 percentage point higher since the announcement; however, over this same period interest rates for longer-term maturities have been essentially unchanged. The comparative stability of most long-term bond rates, as well as the improvement in the dollar's exchange value, is most encouraging and suggests that we may be beginning to reduce inflationary expectations.

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A downward adjustment of price expectations is an essential condition to slow the treadmill of inflation, and monetary policy has an important role to play in this regard. However, at the same time, the Federal Reserve will continue to encourage a moderate expansion of over-all activity, thus also facilitating the achievement of the Nation's longer-run goals of growth and full employment. Moreover, as I have emphasized before, monetary policy should not be expected to shoulder the burden alone, and to be effective, it must also be accompanied by prudent restraint of fiscal policy.

Since April, credit conditions have become progressively tauter as Federal Reserve policies have allowed market rates to rise appreciably in order to help restrain expansion in money and credit. Yields on most short-term market instruments, such as Federal funds and commercial paper, have risen more than 3 percentage points during this period, while interest rates at the longer end of the maturity spectrum generally have risen by less than a percentage point.

Experience over recent years has taught us, however, that in an inflationary environment, expectational considerations tend to buffer the impact of high interest rates on spending. Expectations of rising prices of real assets may induce borrowers to incur high interest costs, as is illustrated by the sustained pace of activity in the housing market thus far this year. Indeed, real interest rates--or observed rates adjusted to take account of inflation--appear to be generally lower than in prior periods, especially if taxes are taken into consideration.

Not only have expectations of borrowers and lenders changed in the course of the current expansion, but also monetary institutions

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have been given additional flexibility to compete for funds. This has helped smooth adjustments of credit markets to developing tightness and, as a result, has helped avoid the repetition of "credit crunch" episodes such as in 1969 and 1973-74. The new 6-month money market certificates, introduced half a year ago, have buttressed deposit growth at mortgage lending institutions when prevailing market interest rates might otherwise have produced disintermediation. Consequently, total housing starts have remained at a very high rate--2 million units--during the first three quarters of this year. Building activity may soon begin to decline, but the drop-off next year should be relatively moderate, making it unlikely that the economy will be thrown into a recession by a sharp housing cycle.

Furthermore, signs generally remain on the positive side for consumer spending, as real consumption outlays currently are rising at about the pace of over-all demands. Nonetheless, this represents a marked slowdown from the rate of expansion earlier in the current upswing. Near-term growth in consumer spending probably will be somewhat restrained by high debt repayment burdens as well as by efforts to boost personal savings rates back to more normal levels.

In the business sector, capital spending activity continues to be characterized by substantial momentum as equipment orders have moved up briskly in recent months and construction contracts have been maintained at a high level. However, the early surveys of 1979 investment plans suggest that businessmen maintain a lingering caution about embarking on major expansion programs. These surveys--largely taken before the November 1 measures--undoubtedly reflected the uncertainty associated with an economy plagued by high inflation.

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On balance, private demands appear healthy at present, but a further moderation of growth is likely over the year ahead. In this environment the Federal Reserve will continue to strive for a gradual deceleration of monetary and credit expansion in an effort to facilitate an easing of inflationary pressures. We believe that the actions taken in late October and early November will prove to be instrumental in the restoration of both domestic price stability and orderly conditions in foreign exchange markets. At the same time, you can be assured that recent measures in the international area were designed to reinforce and not to sacrifice the achievement of longer-term domestic aims.

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