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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

January 30, 1979

Mr. Chairman, members of the Joint Economic Committee, I appreciate the opportunity to participate on behalf of the Federal Reserve Board in your annual hearings on the state of the economy. We find ourselves at an important juncture in our nation's economic progress, a time when patience and persistence are needed until the nation's anti-inflationary economic policies begin to achieve significant results.

The current expansion in economic activity has now almost completed its fourth year--an impressive performance by historical standards. The rate of economic growth moderated somewhat in the past year, yet employment gains were exceptionally large, and major imbalances generally associated in the past with a maturing business expansion did not materialize. There were, however, a number of disturbing developments. In particular, the rate of inflation, already far too high, accelerated further, the foreign exchange value of the dollar declined substantially prior to November, and the level of consumer debt rose sharply.

Outlays for business fixed investment grew strongly in 1978, and housing activity remained at a high level through the year-end. Consumer spending, buttressed by further large increases in consumer credit, continued to provide support for the expansion. Total employment rose by more than 3 million persons during the year; although the labor force also increased rapidly, the unemployment rate declined about 1/2 percentage point to just under 6 per cent at year-end.

The further expansion in economic activity last year appreciably reduced the margin of unutilized resources in the economy. Skilled workers were in increasingly short supply, and industrial capacity utilization rates moved closer to peaks reached in recent cycles. In these circumstances, the moderation in economic growth last year was a desirable development since a more rapid rate of expansion in aggregate demand could well have exacerbated our already serious inflationary problems.

The general level of prices rose sharply in 1978, with the rate of inflation accelerating to about 8-3/4 per cent compared with 6-1/2 per cent in 1977. While the moderation in the pace of economic expansion and the lack of significant distortions in major sectors of the economy augur well for the economy's further expansion in the months immediately ahead, the longer-run performance of the economy will depend critically on our success in bringing down the rate of inflation.

Containment of inflationary pressures in our domestic economy is also a major prerequisite for strengthening the dollar in foreign exchange markets while reducing our trade deficit. In 1978 the deficit was about $35 billion, on an international accounts basis, and the value of the dollar against major foreign currencies fell 17 per cent over the first 10 months of the year. Since November 1 when new domestic monetary policy actions and dollar support measures were initiated, the dollar has risen about 7 per cent. The vigorous implementation of the support program through cooperative exchange market intervention has been successful. The expansion of Federal Reserve swap arrangements and the marshalling of other resources have proved very useful in correcting the excessive decline of the dollar. However, the longer-run strength of the dollar will depend on reducing our domestic inflation, increasing our exports, and curbing our oil imports.

Another worrisome aspect of our economy's performance has been our lagging rate of productivity growth. The poor performance of productivity has retarded the rise in living standards and aggravated the inflation problem. There are many causes of this retarded growth, some of which hopefully reflect temporary developments, but tax policies that pay insufficient attention to investment incentives and government over-regulation must rank high among the contributing factors.

In domestic financial markets, conditions have tightened considerably over the past year. Since the beginning of 1978, short-term interest rates have increased 3 to 4 percentage points; mortgage rates about 1-1/2 percentage points; and bond yields about 1 percentage point. Despite higher interest rates, funds for creditworthy borrowers have remained in ample supply. The total volume of net funds raised in credit markets was lower in the second half of 1978 than in the first half, but total credit flows remained large as borrowing by households in the form of mortgages and installment credit continued to expand at a rapid rate.

The acceleration of inflation over the past year has required major adjustments in economic policies. In the fiscal policy sphere there has been a dramatic movement toward tighter control over government spending and a related reduction in current and prospective Federal deficits. The deficit specified for fiscal 1979 in the First Concurrent Budget Resolution was $60 billion, but this was cut to $39 billion in the Second Resolution. This very impressive reduction was a result of highly commendable actions by the President and the Congress that cut contemplated expenditures and moderated proposed tax reductions incorporated in the original financial plan for the year. More recently, President Carter has announced a budget for fiscal 1980 that would reduce the yearly deficit further--to $29 billion, by far the lowest level in 6 years. There seems to be widespread support for this initiative, and the prospects favor a further move toward budgetary balance in fiscal 1981 and actual balance by fiscal 1982, if not before.

A second policy initiative in the fight against inflation was the Administration's introduction on October 24 of a broad-based program calling for voluntary moderation in wage and price actions, the establishment of specific standards for wage and price increases, and the offer of various incentives for compliance. Past experience has suggested that incomes policies are of limited effectiveness in reducing the underlying rate of inflation. Yet, an incomes policy can play an important role in circumstances where more basic economic policies are being redirected in a vigorous way toward the containment of inflation. I am confident that most business and labor leaders will abide by the spirit of an incomes policy if they perceive that the

Administration, the Congress, and the Federal Reserve are truly determined to bring inflation under control.

Monetary policy also moved toward increased restraint in the past year as the Federal Reserve sought to foster financial conditions that would contribute to a reduction of inflationary pressures while supporting continued moderate economic growth. Accelerating inflationary pressures were accompanied by rising demands for money and a tendency for the monetary aggregates to expand at rates that were widely viewed as excessive. In the circumstances open market operations became progressively less accommodative in the provision of reserves and the Federal funds rate rose from around 6-1/2 per cent in early January to about 10 per cent recently. The discount rate was increased in a number of steps by 3-1/2 percentage points during 1978, to 9-1/2 per cent. These anti-inflation moves featured actions taken on November 1 in conjunction with the dollar-support program: the System announced a one percentage point increase in the discount rate, imposed a two percentage point supplementary reserve requirement on large-denomination time deposits, and further tightened reserve availability through its open market operations.

Growth in the narrowly defined money stock, M-1, slowed sharply in the final quarter of 1978. The cumulative impact of rising short-term interest rates has undoubtedly helped to restrain the growth of money. But recently, the public has shown a tendency to economize more than might have been expected on their holdings of cash balances.

Persisting high levels of short-term rates and the availability of alternative transactions-type accounts, such as the new savings accounts with an automatic transfer feature, have probably caused many depositors to shift sizable amounts of funds out of demand deposits. Expansion in the broader measures of money, M-2 and M-3, also moderated late in the year, reflecting not only the sluggish performance of their M-1 component but also the weakness in time and savings accounts subject to fixed-rate ceilings. Rising yields on competing market instruments tended to make such accounts increasingly less attractive as the year progressed. In contrast, time deposits paying interest rates competitive with those on market instruments have continued to attract sizable inflows of funds to banks and nonbank thrift institutions.

The tightening of financial conditions has been accompanied by erosion of liquidity positions in various sectors of the economy. Mortgage and consumer debt burdens rose sharply in 1978 and the ratio of mortgage and consumer debt repayments to disposable income reached a record high. Borrowing by nonfinancial corporations was concentrated heavily in short- and intermediate-term liabilities, especially bank loans and commercial paper, and the ratio of short- to long-term business debt is now only slightly below the 1974 peak. Commercial banks have reduced their holdings of U.S. Government securities and increased their use of interest-sensitive liabilities such as large-denomination CD's and security repurchase agreements. Savings and loan associations have borrowed a record amount from Federal Home Loan Banks. The reduced liquidity of many individuals, business concerns, and financial institutions is likely to exert a moderating influence on credit-financed expenditures.

It should be emphasized that the much needed firming in credit market conditions has not been accompanied by the severe strains and distortions associated with past periods of credit restraint. Current interest rate levels may be inhibiting some potential borrowers, which is the objective of credit restraint, but creditworthy borrowers continue to find funds available at prevailing rate levels. The housing market in particular has continued to attract a relatively abundant share of financing, though at rising interest rates. A key factor in this development was the introduction in June 1978 of new 6-month money market certificates that have enabled depository institutions to attract funds by paying prevailing market interest rates. In addition, housing has been supported by the lending activities of the Federal Home Loan Banks, the emergence of new mortgage-related securities, and the improvement of secondary markets for mortgages. The net increase in mortgage debt in the fourth quarter of 1978 was only a little below the record increase in the fourth quarter of 1977.

Mr. Chairman, you have asked me to assess the economic outlook. The major threat to the economy is inflation and the concomitant expectations that dominate the setting of prices and wages. Thus, any weakening in our anti-inflationary resolve could seriously damage our domestic economy and have adverse implications for the external value of the dollar.

Policies of fiscal and monetary restraint--together with the cooperation of business and labor in the Administration's wage-price program--can achieve a gradual reduction in the rate of inflation, with progress becoming evident during 1979. While growth of output and employment is expected to slow this year, a recession is unlikely in the absence of outside disturbances to the economy. A moderate rate of economic growth is likely to avoid financial and economic dislocations, such as overinvestment in business inventories, which in turn could foster a recession later. The economy is already quite close to full employment and any new surge in demand must be prevented since it would only be translated into more inflationary pressures.

Spending by consumers, a mainstay of our economic expansion since the spring of 1975, will probably continue to grow but at a reduced pace in light of the increased consumer debt burdens noted earlier. Expenditures on new plant and equipment by businessmen seem likely to be well maintained and they may even increase more than is currently anticipated if visible progress is perceived in the fight against inflation. In the housing area, some decline from the current high level of activity seems probable as financial restraints exert a retarding influence on both builders and homebuyers. Nonetheless, the severely depressed conditions that have periodically affected this sector of the economy will most likely be avoided. Adequate financing will continue to be available thanks to the wide range of government support programs and the access of home-lending institutions to market sources of funds such as the new 6-month certificates. Prospects for our trade balance in 1979 also seem to be brightening.

In your letter inviting me to these hearings, Senator Bentsen, you have asked for comments on the appropriate mix of fiscal and monetary policies. In the area of monetary policy, the restraint that has been put in place is achieving welcome results in the form of a reduced rate of monetary expansion. As may be seen from charts 6 to 8, the monetary aggregates have generally moved into the ranges set by the Federal Open Market Committee. The Federal Reserve is determined to achieve a rate of monetary growth that is consistent with the objective of fostering a decline in the rate of inflation while encouraging moderate economic expansion. The Federal Reserve's task will be eased immensely if fiscal policy remains on the course outlined by the President. Large budget deficits tend to put upward pressure on interest rates as Government demands compete with private demands for funds. It is therefore essential for the Congress to resist programs that lead to increased expenditures. A reduced Federal deficit, including borrowings by off-budget agencies, would ease pressures on interest rates and allow the Federal Reserve to achieve its monetary growth objectives at lower interest rates than otherwise. A reduced budgetary deficit would also foster a financial environment that encourages greater business investment and would improve the prospects for a period of sustained economic growth and a moderating rate of inflation.

Chart 1

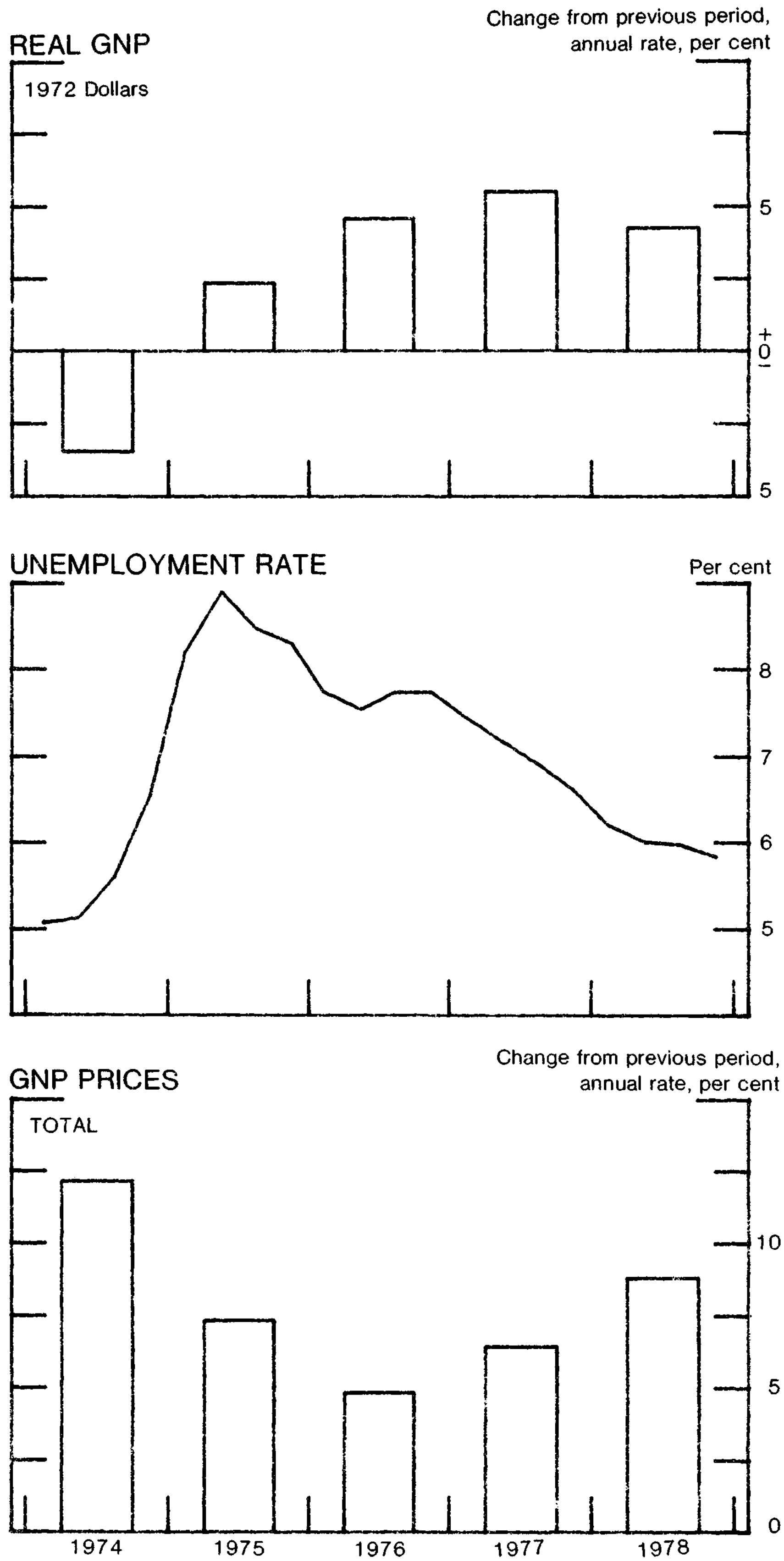

REAL GNP
Change from previous period, annual rate, per cent
1972 Dollars
5
+
0
−
5
UNEMPLOYMENT RATE
Per cent
8
7
6
5
GNP PRICES
Change from previous period, annual rate, per cent
TOTAL
10
5
0
1974
1975
1976
1977
1978

Chart 2

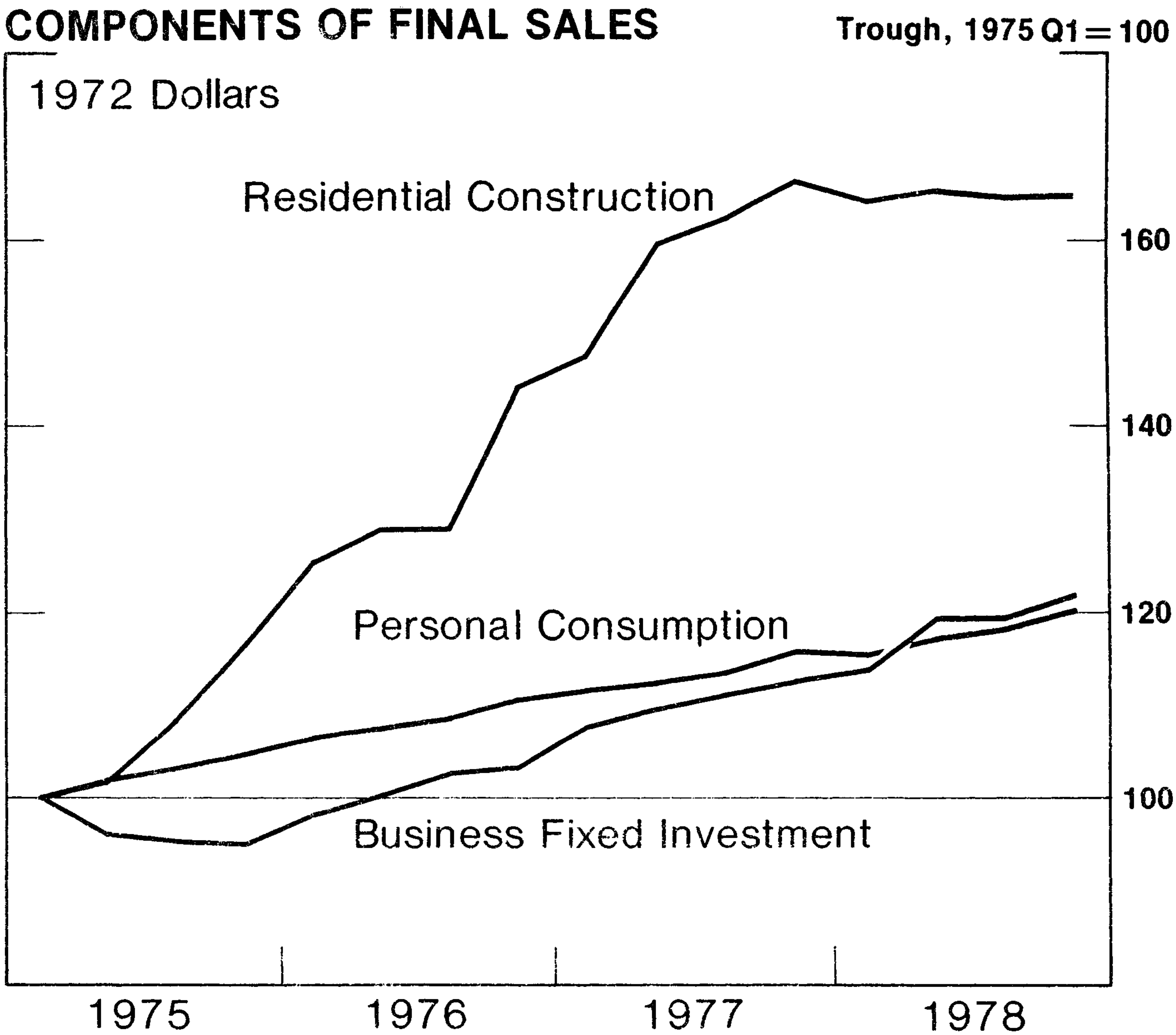

COMPONENTS OF FINAL SALES
Trough, 1975 Q1 = 100
1972 Dollars
Residential Construction
Personal Consumption
Business Fixed Investment
160
140
120
100
1975
1976
1977
1978

Chart 3

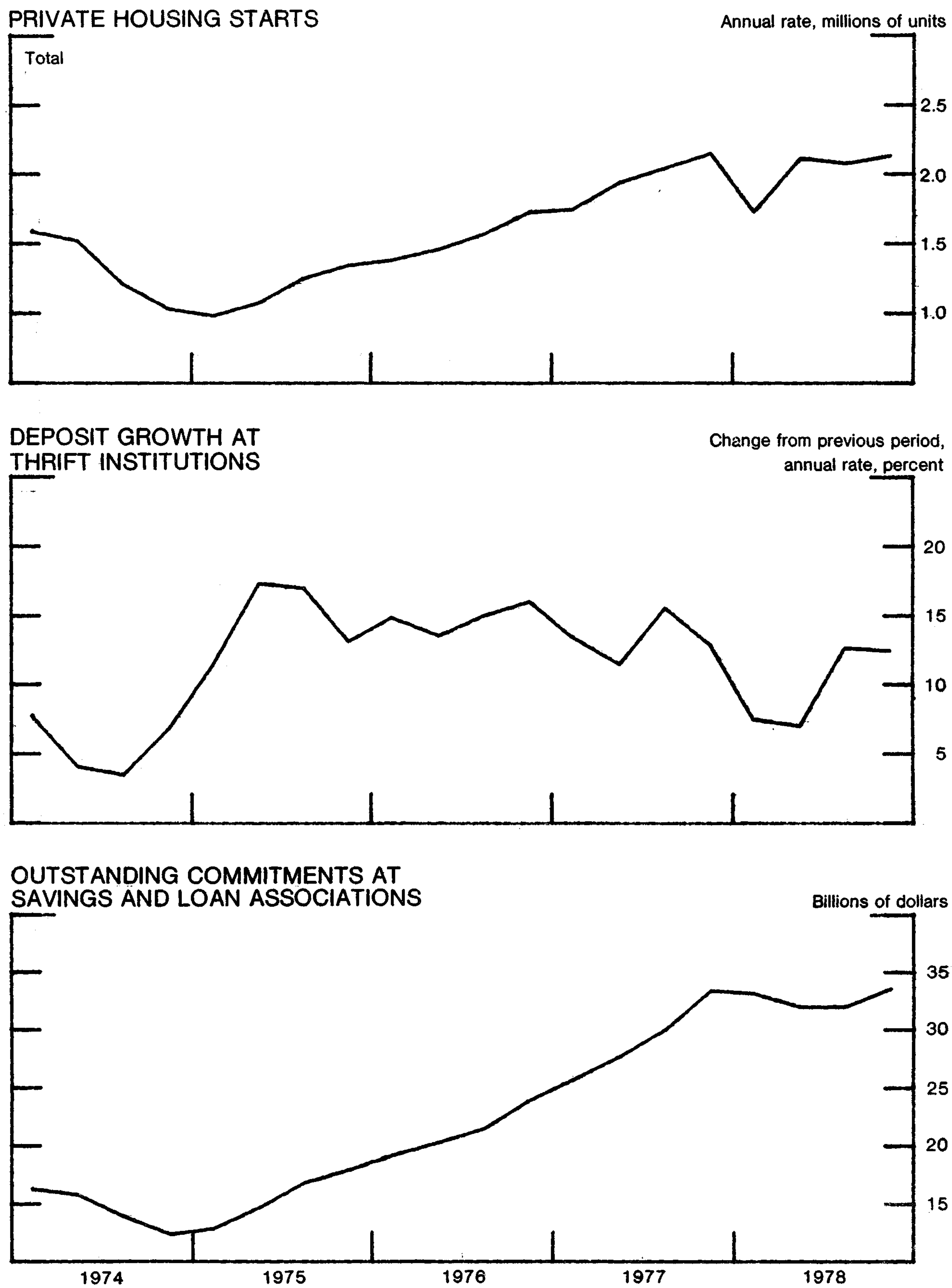
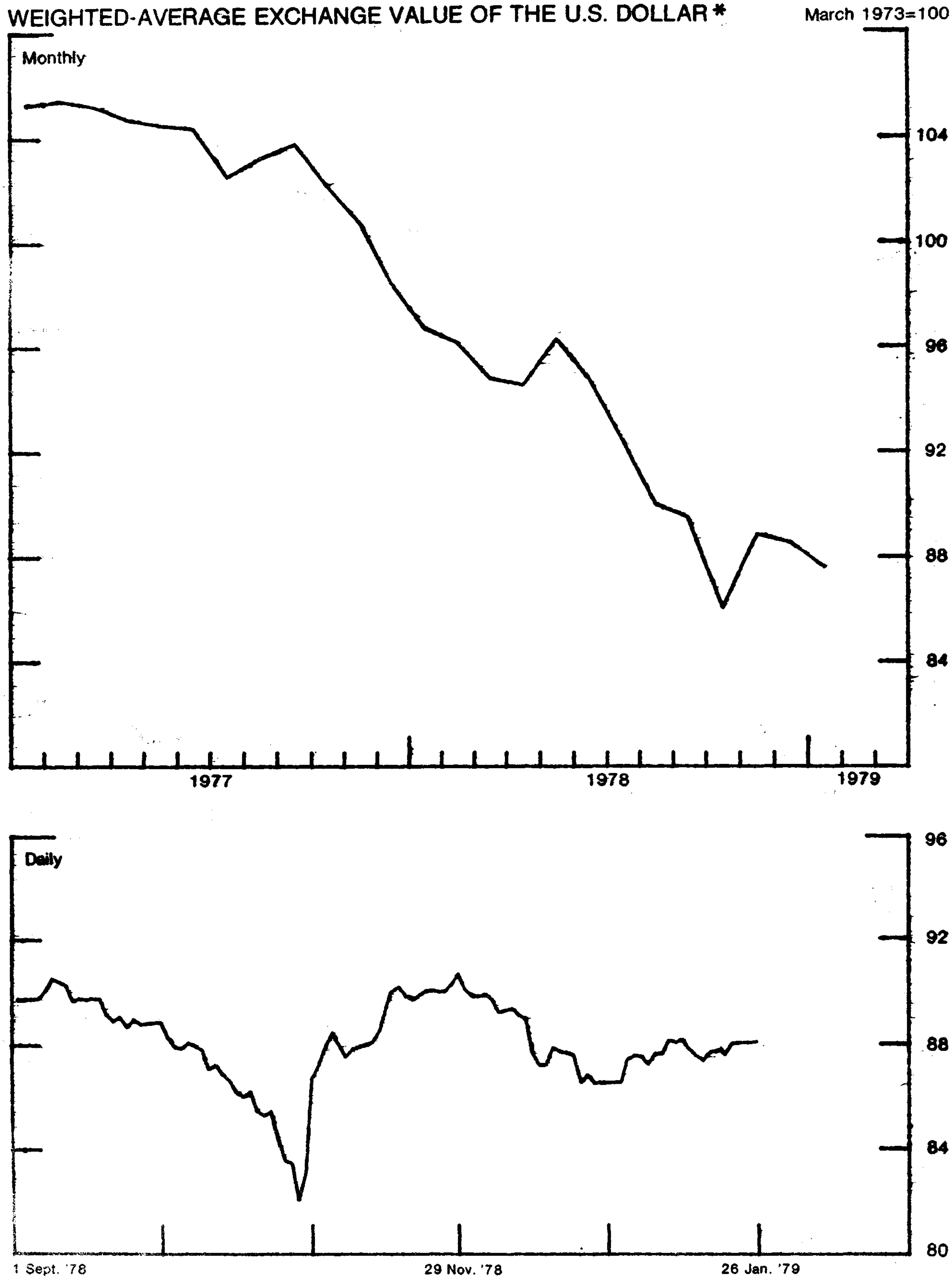

PRIVATE HOUSING STARTS
Annual rate, millions of units
Total
2.5
2.0
1.5
1.0
DEPOSIT GROWTH AT THRIFT INSTITUTIONS
Change from previous period, annual rate, percent
20
15
10
5
OUTSTANDING COMMITMENTS AT SAVINGS AND LOAN ASSOCIATIONS
Billions of dollars
35
30
25
20
15
1974
1975
1976
1977
1978

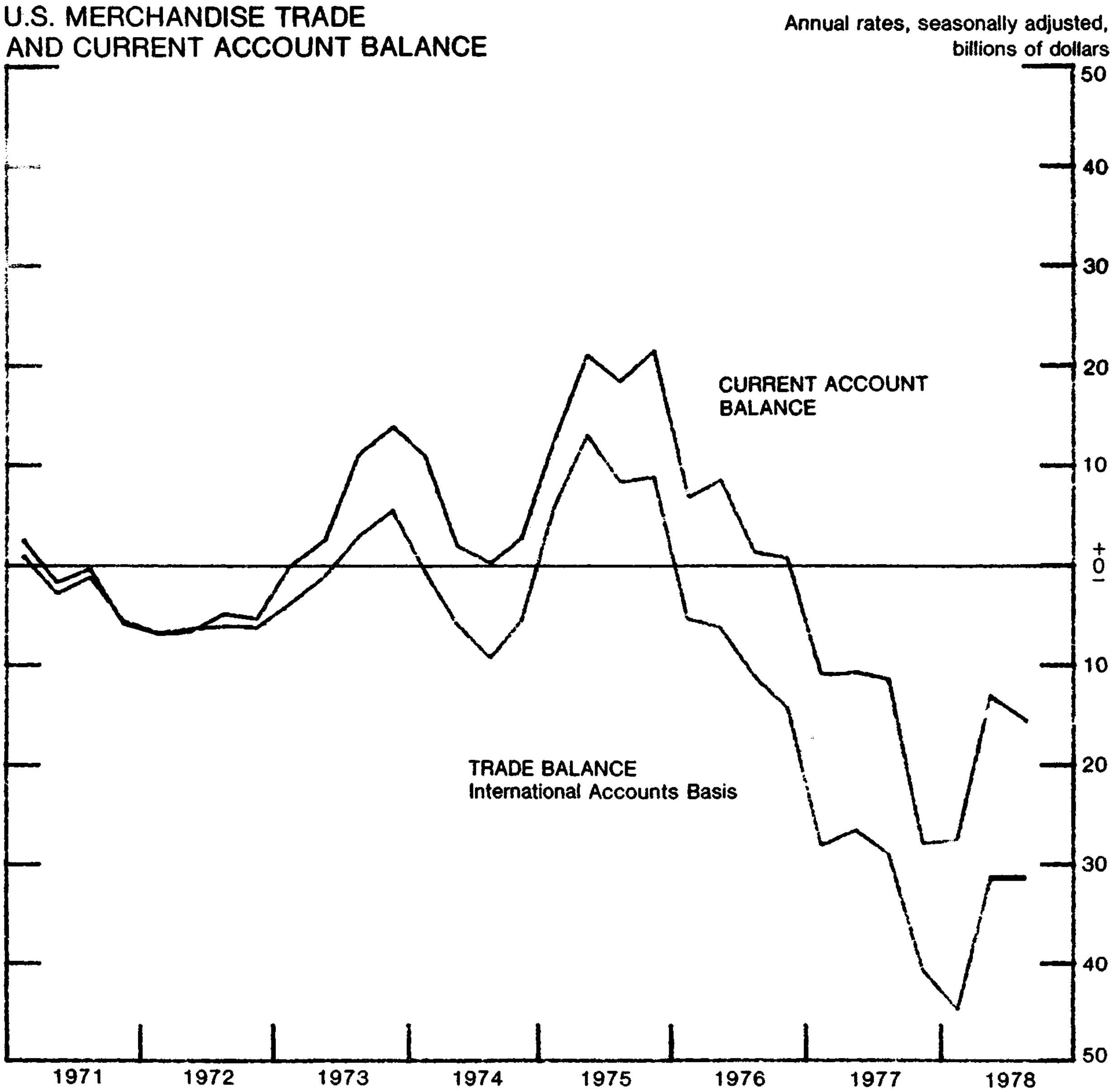
Chart 4

WEIGHTED-AVERAGE EXCHANGE VALUE OF THE U.S. DOLLAR *



* Index of weighted average of G-10 countries plus Switzerland.
Weights are 1972-76 global trade of each of the 10 countries.

Chart 5



U.S. MERCHANDISE TRADE
AND CURRENT ACCOUNT BALANCE
Annual rates, seasonally adjusted,
billions of dollars
50
40
30
20
10
+
0
−
10
20
30
40
50
CURRENT ACCOUNT
BALANCE
TRADE BALANCE
International Accounts Basis
1971
1972
1973
1974
1975
1976
1977
1978

Chart 6

Recently Established M-1 Growth Ranges and Actual M-1

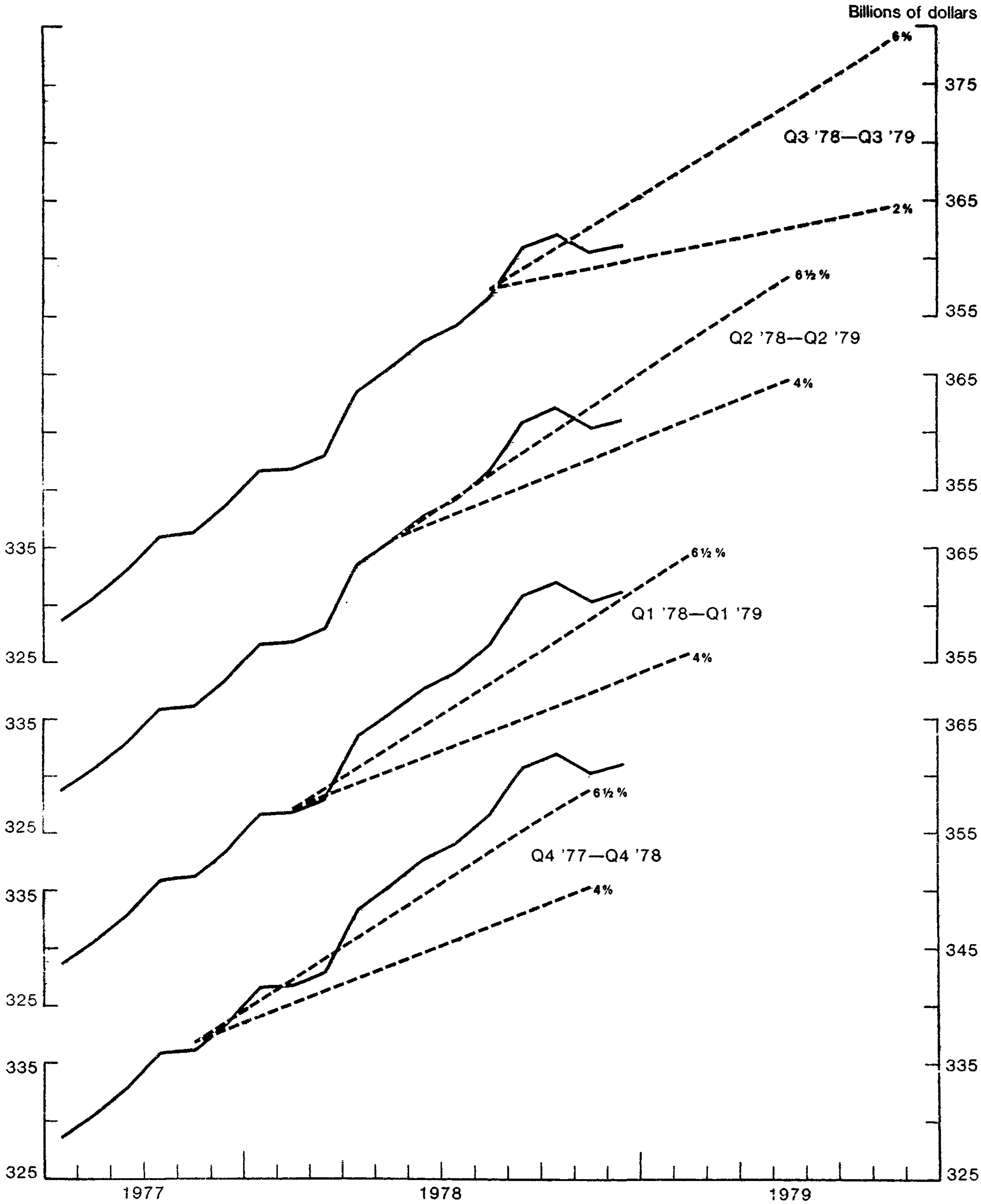


Chart 7

Recently Established M-2 Growth Ranges and Actual M-2

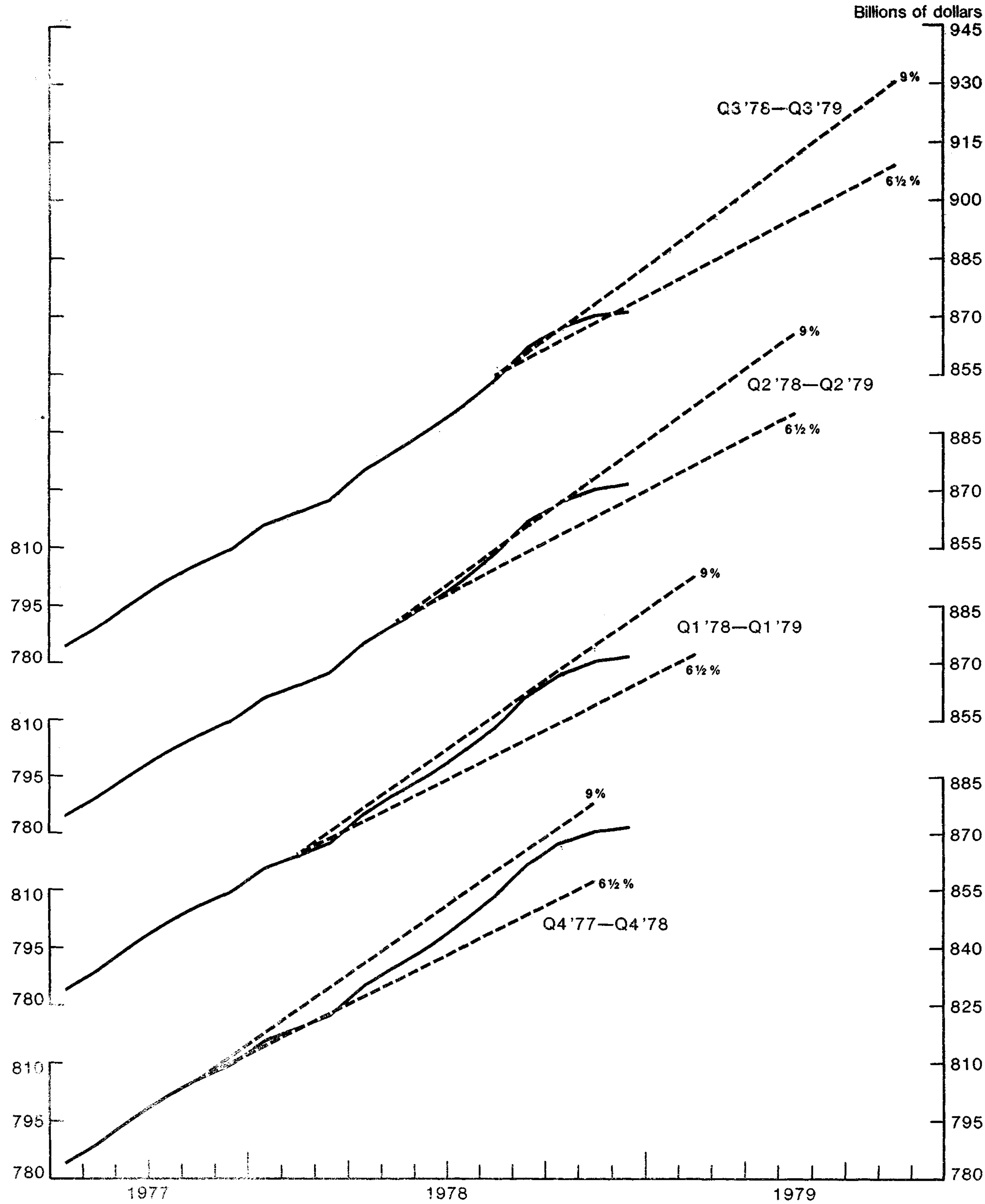


Chart 8

Recently Established M-3 Growth Ranges And Actual M-3