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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I am pleased to have the opportunity to meet with this committee to discuss the current economic situation As you know, the Federal Reserve's most recent official monetary policy report was submitted to the Congress in mid-July. Because that report treated the economic situation in considerable detail, my remarks on the current economic and financial situation will be limited mainly to an updating. More importantly, I also would like to reemphasize a number of concerns that I expressed at the time that the midyear report was submitted to the Congress.

At that time, it was evident that the current economic recovery had gained considerable momentum and was following in many respects a typical cyclical pattern. Advances in residential construction had been large; consumer spending had registered exceptional increases in the spring; and business investment spending also was beginning to strengthen. Employment gains were substantial through the first half, and the unemployment rate -- though still high -- had moved steadily

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lower. By midyear, only the export sector remained a major depressant on growth of real GNP, reflecting the further widening of this country's foreign trade deficit.

By and large, the economic trends evident at midyear have continued through the third quarter. Industrial production has continued rising at a rapid pace through September. Payroll employment increased nearly two-thirds of a million during the three months ending in September, and the unemployment rate fell three-fourths of a percentage point over that same period. Preliminary indications suggest growth in real GNP remained fairly close to the exceptionally high rate in the second quarter. On the whole, I believe that the data indicate that the economy remains firmly on the path of expansion.

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Moreover, the recent price information continues underscore the gains made against inflation over the past two or three years. During the first eight months of 1983, the consumer price index rose at about a 3-1/2 percent annual rate, somewhat less than the rate achieved in 1982, and the producer price index, on balance, has showed virtually no change over that same period. This price information is better than we have experienced in a decade or more, in sharp contrast to the racheting upward of prices in the 1970's.

Because labor inputs account for about two-thirds of total GNP, an easing in growth of labor costs is crucial if our gains against inflation are to prove sustainable. On this score, we have made further progress so far this year. The rate of increase in nominal wage gains has trended down; the hourly earnings index, the most current wage measure, has risen at a rate of less than 4 percent this year. The easing of cost pressures has been reinforced by rapid

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oductivity gains that appear to reflect not only the cyclical gains normally associated with the early stages of expansion, but also some apparent improvement in the trend rate of productivity growth. It is this kind of pattern, that sustained, can keep the underlying inflation rate moving lower -- and real wages rising.

Overall, these recent indicators of economic activity, inflation and productivity provide a strong start toward a much more satisfactory economic performance than we have seen for many years. At the same time, as I have said many times before, what counts is not the rate of economic growth over a short time span of a few months, or even a few quarters, but rather the performance of the economy over time. The current expansion, though more robust than generally expected at the beginning of the year, still is less than a year old. And, on the surface, it could be said that recent events do not differ dramatically from the early phases of some earlier business cycles that also began with strong growth and improved price performance -- but later deteriorated into

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accelerating inflation and stagnating real activity. That past record should be warning enough to resist any temptation to sit back and let events take their course, hoping that the momentum of expansion and the progress already made against inflation will be sustained pretty much on their own.

Moreover, there are obvious potential obstacles in the path to sustained progress. Most importantly, the current prospect that federal budget deficits will remain exceptionally large into the indefinite future is a major factor propping up interest rates and continues to pose a serious risk to the stability of financial markets in the future, threatening the balance and ultimate sustainability of the recovery itself. The economic and financial problems of many developing countries -- aggravated by the high level of dollar interest rates -- remain a dark cloud over the international financial system, and unless contained could jeopardize our own economy. And, despite our substantial progress against inflation, doubts about the sustainability of that process, and temptations to revert to attitudes and behavior characteristic of the 1970's, could

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undermine prospects for continuing economic expansion.

these respects, we are in a period of testing.

It is well within our capacity to pass these tests. But it will take a positive approach, not a wait-and-see attitude. Data for the past fiscal year provide some sense of the budgetary problem; in fiscal 1983 the federal budget deficit, not counting Treasury financing of off-budget programs, apparently reached close to $200 billion, nearly twice as large as the previous year's deficit, which itself had been of record proportions. The 1983 federal deficit amounted to about 6-1/2 percent of nominal GNP: prior to 1983, there had been only one year in the past three decades in which federal deficits were as much as 4 percent of GNP.

Obviously, the magnitude of the federal deficit in future years will depend on both the actions of Congress and on the strength of the economic recovery. A large portion of the 1983 deficit -- perhaps half -- reflected the influence of the business cycle on federal receipts and expenditures. As the economy improves this "cyclical" element in the deficit will become smaller.

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But given currently existing legislation, the non-cyclical, or "structural" part of the deficit is all too likely to rise further. Indeed, under even the most optimistic economic assumptions now being made, the federal deficit appears likely to remain at levels, relative to the size of the economy, that are without historical precedent during periods of economic expansion.

A year ago there appeared to be a growing commitment in the Congress to address the problems associated with federal deficits. Today, I fear the sense of urgency has dissipated. Instead, with the economy growing again, there may be a temptation to try to live with historically unprecedented peacetime deficits.

That course implies great hazards. Even in the period just completed -- during which private credit growth was reduced substantially by the recession -- the influence of heavy federal borrowing contributed to the persistence of high interest rates. Maintaining large deficits in coming years

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makes it far more likely that interest rates will remain historically high well into the recovery, and posing a risk to the sustainability of the expansion.

The progress we have made against inflation - if sustained is one fundamental force that should tend to make interest rates lower over time. But the huge budget deficits have an impact in the opposite direction. One result is to dampen prospects for business investment, particularly for long-lived investment with relatively slower "pay-out." But that investment is what is needed to revitalize some of our basic industries, and to support productivity generally.

Some of those same industries also suffer from depressed exports or strong import competition. To the extent that large capital inflows are induced by pressures on our domestic capital and credit markets, those inflows have contributed to maintaining the dollar at "artificially" high levels, viewed from the perspective of the current competitive position of our industry. In the short-run, those capital inflows may

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help to moderate pressures on the financial markets. But, viewed in a longer perspective, we have the irony of the largest and richest country in the world in effect turning to foreign investors to help finance its government deficits while, by the same process, draining vitality from the firms and industries that in the past have been important exporters. As I noted earlier, exports have been a weak element in the business picture, and our trade and current account deficits are growing toward levels that would be unsustainably large. The longer that process lasts, the greater the potential instability for the U.S. and for the world economy.

The persistence of large federal deficits and a high interest rate environment also complicates the effort to deal with the international debt situation. The developing countries -- excluding those that are members of OPEC -- have a total indebtedness of about $575 billion. Of that total, about $285 billion is owed to banks around the world, with more than $100 billion owed to U.S. banks. The level of indebtedness is high relative to the current income-generating

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potential of those economies, and the great bulk of the debt is in dollars, paying dollar interest rates. As you know, difficulties in servicing these debts have been widespread.

Thus far, problems have been contained through an extraordinary degree of cooperation among borrowers, private creditors, national authorities, and international organizations. The borrowing nations themselves have undertaken strong adjustment measures to restore financial stability, increase debt-servicing capacity, and improve their credit-worthiness. There also has been a major cooperative effort among the lending banks to agree upon financing programs involving the restructuring of existing debts and provision of some new loans.

At the center of this process have been the coordinating efforts of the International Monetary Fund. On several previous occasions when I have testified before the Congress, I have urged prompt action to bolster the resources of the IMF. However, as you know, the work on that important legislation has not been completed.

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International understandings look toward action before the end of next month, so time is growing short. Apart from the actual funds involved, our failure, alone among nations, to participate in this effort would send a strong message around the world that we do not support the cooperative efforts to manage and contain the debt problems of the developing countries. Put positively, participating in the proposed increase in IMF resources is a necessary and prudent investment in our own future.

Another important element to dealing with the current external financing problems of developing countries is a concerted effort to maintain the flow of bank credit to these countries. The question is sometimes raised whether such lending will be at the expense of lending to domestic borrowers and the expansion of our own economy. In that connection, I would emphasize the new bank lending to these countries will, in the aggregate, be at a substantially reduced pace from that of recent years and, as I have noted, we are on balance currently large net

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borrowers from the rest of the world. In the absence of these cooperative lending efforts by banks and the IMF, I do not believe we could be successful in avoiding widespread defaults or worse. The clear threat would be that such an international financial disturbance would have major repercussions on our own credit markets, our interest rates, and our growth prospects -- far outweighing any effects on our markets of the limited foreign lending required to maintain stability internationally.

Finally, I must emphasize the crucial importance of maintaining the progress against inflation. As I noted earlier, looking back, the recent data on prices and wages is favorable. However, it is also true that some temporary factors for a while caused measured rates of inflation to exaggerate the slowdown in underlying rates of inflation. As temporary factors have subsided, there has been some increase in reported monthly rates of price increase from the essentially flat record of the first half. That is not, in itself, surprising, but it does warn against any sense of complacency.

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The fact is there continue to be deep-seated concerns both in financial markets and among the general public that more strongly inflationary trends could soon resume. The experience of the 1970's with accelerating inflation, despite some cyclical "pauses," is still deeply ingrained in people's minds, and, looking ahead, there is concern about whether appropriate restraint will be maintained over money and credit growth in the face of sustained huge deficits.

There are strong grounds for believing that these attitudes and expectations may be lagging behind reality and that underlying inflation rates are lower -- and can continue to move lower -- than is generally perceived. Indeed, with the period of low inflation still lengthening, with spare capacity still extensive in many sectors, and with strong domestic and international competition, and with labor amply available, there is a rare opportunity to "build in" greater stability.

Whether that optimistic view will, in the end, prove correct depends in part on the attitudes and behavior of

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business and labor. We currently see strong efforts to contain costs and improve efficiency in industries subject to the most intense competitive pressure, whether because of depressed markets or other factors. In some other areas, new wage contracts or pricing policies appear out of touch, both with our recent experience with inflation and with current conditions in labor or product markets generally. Rather, we see symptoms of a kind of carryover -- or a "hangover" -- of attitudes instilled in a more inflationary environment. Should those attitudes be reinforced and generally prevail, our effort to move toward sustainable economic growth with greater stability would be greatly complicated.

Experience suggests expectations developed over a lengthy period of accelerating inflation are rarely suddenly changed. But they will change over time, so long as public policy remains steadfast in its commitment to an environment of greater price stability.

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Monetary policy inevitably must play a central role in that process, essentially by containing growth of money and credit to amounts consistent with containing inflation over time. I doubt that such efforts can ever be reduced, in a complex changing economy like ours, to a simple mechanical formula to govern growth in one measure of the money supply or another. For instance, in the midst of both institutional and economic change last year and during the early part of 1983, the Federal Reserve accommodated faster growth in some of the various monetary aggregates than it had planned earlier, responding in part to the visible evidence of a pronounced slowdown in the turnover or "velocity" of money. With some indications that more normal patterns may be returning, and with the momentum of recovery strong, limited steps were taken to resist monetary and credit growth during the spring and early summer. In a real sense, in a climate sensitive to inflation and the possible future inflationary

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implications of current policy, timely steps to pre-empt excesses can avert the need for much stronger action later.

In recent weeks, all the monetary and credit aggregates have moved comfortably within the target ranges, easing concerns of a surge in liquidity growth. In addition, interest rates, for the most part, have edged slightly lower in recent weeks, following moderate increases in late spring and early summer. But the looming budget deficits remain as a focus for doubts about the future.

In conclusion, the economic situation, in its broadest terms, does not differ dramatically from the situation that was apparent at midyear. Current economic indicators have continued to show a strongly growing economy coupled with only moderate rates of inflation. At the same time, concerns about the longer run outlook that were apparent at midyear are still with us today. Now, as then, we broadly know what policies are needed to provide greater assurance

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of sustained economic growth and lasting price stability. What remains to be done is to implement those policies.

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