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Statement by

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before the

Committee on the Budget

United States Senate

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Mr. Chairman, members of this Committee, the budget deliberation process plays a critical role in the formulation of public policy, and I am pleased to present the views of the Federal Reserve as the Committee develops the First Concurrent Budget Resolution for fiscal year 1980. The direction that fiscal policy takes over the next several years will be of strategic importance in determining the Nation's ability to meet its longer run goals of growth, high employment and price stability. While your task is a difficult one, it provides a clear opportunity for Congress to help unwind years of corrosive and persistent inflation.

Economic activity over the past year was highlighted by a sizable rise in real GNP together with a marked acceleration in the rate of price increase. By the end of 1978, the current economic expansion was close to its fourth anniversary and, when compared with prior cyclical upswings of the postwar period, it is notable both for its longevity as well as its strength. As indicated in Chart I, the 4-1/4 per cent rise in real GNP over 1978 represented something of a deceleration from the 5-1/2 per cent pace of the first three years of expansion. But with the economy's movement into a zone where resource pressures can be intense, this slowing was desirable, especially given the recent signs of acceleration of raw materials price increases. Over the year the unemployment rate fell further by half a percentage point to 5.8 per cent of the labor force, and at year-end there was relatively little job market slack in many of the higher skilled occupational groups. Similarly, capacity utilization moved up to about 86 per cent in manufacturing, and while the emergence of any production bottlenecks generally has been avoided, this sector of the economy is operating quite close to its pre-recession rate. Despite this diminished slack in the economy, last year's intensification of inflationary pressures can be attributed largely to sources other than pressures of resource constraints. However, further brisk expansion of the economy at this time runs the risk of adding yet another source to an already intractable inflation.

The acceleration of price increases during 1978 was clearly the major disappointment in the economy's performance. Unlike earlier years, when worsening inflation could be associated with one or two unfavorable and isolated developments, the acceleration last year was broadly based and resulted from both endogenous as well as special occurrences. Food prices skyrocketed early in the year as the severe winter weather took its toll on the agricultural sector. In addition, the cost of homeownership rose sharply as home purchase prices and mortgage interest rates increased, and the weakening exchange value of the dollar had adverse implications for prices of imports and for those domestically produced goods that compete with imports. However, even after allowing for these somewhat "special" considerations there was an acceleration of inflation in most other areas as well; these trends are summarized in Chart II. The deterioration of this underlying rate of price increase can be most clearly associated with last year's pick-up in unit labor costs. In turn, the continued uptrend in costs can be attributed in large part to a most disappointing productivity performance and to legislated increases in the minimum wage and in payroll taxes for social security and unemployment insurance.

Unfortunately, likely developments over the course of this year do not suggest a significant easing of inflationary pressures in the near-term. Another round of mandated increases in payroll taxes went into effect the first of the year and these costs tend to be passed through to prices quite promptly. Also, given recent reports on spot prices of crude foodstuffs, it is a virtual certainty that retail food prices will increase sharply in the first quarter. Furthermore, large OPEC oil price hikes have been scheduled for this year and the impact of the dollar's depreciation has yet to run its course. These factors, combined with a heavy collective bargaining calendar following the price run-up of 1978, makes it difficult to envision overall price increases slowing markedly from last year's 9 percent range.

Given this developing environment there was a clear and urgent need for the stance of public policy to shift toward the restraint of aggregate demand and focus on actions designed to end the self-fulfilling prophecies of inflationary expectations. The Administration's anti-inflation proposals of late October were aimed at disentangling the interplay of wages and prices through the recommendation of wage-price standards. In addition, the program underscored the inflationary tendencies of Government policies by stressing that fiscal restraint and regulatory reform were both necessary for an effective assault on inflation. These proposals were reinforced by the joint actions of the Treasury and the Federal Reserve on November 1 that helped restore stability to the international value of the dollar. Fiscal policy also moved toward restraint last year. The $44 billion Federal deficit for calendar year 1978 was $7 billion less than in the prior year and well below that implied by the first and second concurrent budget resolutions. Nonetheless, a continuing deficit of this magnitude is far too large for a maturing expansion beset with inflationary difficulties.

Monetary policy also moved clearly in the direction of restraint during 1978. Interest rates for short-term market instruments rose about 3 to 4 percentage points over the course of the year and yields at the longer end of the maturity spectrum rose around 1 percentage point. These appreciable advances in market rates reflect a monetary policy that continues in its efforts to foster financial conditions consistent with a moderation in the pace of economic activity and a slowing of inflation. Real interest rates--or market rates adjusted for inflation--still appear to remain low by historical standards and thus continue to facilitate an expansion of overall demands. Furthermore, due to the evolution of the structure of financial markets in recent years, there is growing evidence that the economy now responds in a smoother fashion to adjustments in monetary policy. A recent example of this development has been the success that the new 6-month money market certificates have had in boosting deposit flows at major mortgage lending institutions during a period when prevailing market rates could have resulted in widespread disintermediation. Thus, despite a tightening of monetary policy, economic activity has not been disrupted by the type of "credit crunch" espisodes that have severely affected financial markets in the past.

The economy's ability to withstand tauter financial markets does not blunt, however, the critical role that monetary policy can play in combatting inflation. The upward movements in interest rates have been accompanied by a reduction in the growth of the monetary aggregates, even after allowance for the recent introduction of automatic transfers from saving to demand accounts. In turn, this moderation of money growth has apparently discouraged some borrowing activity recently, especially in the commercial and industrial sector. Furthermore, given the normal lags of policy impacts, the expansion of total credit demands should be further restrained in the months ahead.

While monetary policy has a key role to play in achieving the Nation's economic goals, it cannot wage the battle alone. The application of prudent restraint through fiscal policy is just as critical if we are to turn our full arsenal of public policies against inflation. It is most important that fiscal and monetary authorities work in tandem towards achievement of the Nation's longer term goals. In a report submitted to the Congress on February 20, in compliance with the Full Employment and Balanced Growth Act of 1978, the Federal Reserve detailed its policy aims for 1979 and concluded that those plans are consistent with the present goals of fiscal policy.

Specific fiscal policy recommendations for the upcoming fiscal year depend critically on the outlook for real GNP growth and inflation. Despite much public opinion to the contrary, there is little evidence, at present, that the economy is threatened with an actual contraction of activity. While the surprisingly strong surge of real GNP in the fourth quarter of last year is not sustainable nor even desirable, it did impart a good deal of momentum to activity that is likely to carry over into the first half of the year; this point is illustrated in Chart III which shows the recent trends of several economic indicators. In the business sector, orders backlogs and construction contracts remain at high levels and are likely to support a moderate expansion of capital spending at least through the spring. In addition, inventories remain quite lean relative to sales and, given the surge in consumption late last year, a rebuilding of stocks could be required in some lines which could further boost production and income. Furthermore, aside from last month's drop in starts which appears to be mostly weather-related, housing construction has been sustained at a relatively brisk pace. As a result, we have avoided a sharp downturn in one area of the economy most prone to cyclical sensitivity.

Nonetheless, there are signs that some weakness to demands could well develop over the course of the year. Surveys of business capital spending intentions point to a slowing of growth in the latter half of this year. Also, it seems likely that housing activity could be reduced somewhat by financial conditions in mortgage markets. And finally, consumption, whose consistent strength has provided a solid foundation for most of this expansion, might slow as income gains weaken and high debt burdens impart a degree of caution to consumer spending decisions.

Overall, while inflation remains a most disruptive influence, there are no signs of the types of imbalances that typically have signalled the onset of prior recessions. In this environment, macro-economic stabilization policies need to aim for a moderating course of activity and the resulting relief of inflationary pressures that would emanate from product, labor, and financial markets. While the outcome of such policies would presumably imply an upward drift of unemployment, the alternative course--that of further demand stimulus--would be fraught with ever greater inflationary perils. The social costs of unemployment can never be ignored, but at this juncture a failure to ease inflationary pressures would be far more costly over the longer run than would be any temporary dislocations in the labor market.

At present, fiscal policy recommendations need to be governed by clear restraint. Continued reduction in the deficit in the near future and movement toward a balanced budget over the next several years is desirable; as shown in Chart IV, the Administration's recent budget proposals represent a positive move in this direction. Not only would the trend toward balance avoid the excessive demand stimulus that has fueled inflation during recent years, but elimination of large Federal deficits also would absorb less private saving and thus provide more of an opportunity for increased capital formation. Furthermore, the deficits of the past several years have been accompanied by Treasury borrowing on a scale large enough to distort flows in private capital markets. And the financing needs of off-budget agencies have acted to exacerbate this problem. As a result, a movement toward fiscal balance would lessen the pressures on our money and capital markets.

A second and related aim of fiscal policy should be a reduction in the size of the government sector in our economy. As Chart V indicates, one of the more undesirable features of economic change over the last 20 years has been the gradual increase in the share of Federal outlays as a per cent of GNP. In the latter half of the fifties the ratio stood at 18.3 per cent whereas by 1976 it has risen to 22.5 per cent. In the past two years the ratio has edged back down but it still remains too high. The 21 percent share projected for fiscal year 1980 is laudable but the reduction should not stop at this point. Achieving such a reduction will require a rethinking of many existing spending programs as well as limitations on new spending initiatives.

At the same time the deficit and the output share of the Federal sector are being reduced, fiscal policy should also be directed at promoting an improved environment for capital spending. As Chart VI indicates, over the past decade our investment share of output has been generally inferior to that of most major industrialized economies. Furthermore, in recent years there seems to have been a reluctance to invest in the heavy machinery that is so essential for the expansion of our productive capacity. Whatever the cause--an excessive regulatory burden, increased foreign competition, or an outmoded technological base--there is a real need for stepping up incentives such as accelerated depreciation and investment tax credits. Not only would this enhance the economy's longer run growth prospects, it would also facilitate resumption of more normal productivity growth. The slowing of productivity gains over the last five years has been most disappointing, and this has contributed directly to the growing inflationary bias of the present expansion. Successful efforts to reverse this trend would improve greatly the economy's potential for non-inflationary expansion.

In sum, fiscal policy needs to be directed in a clear and forceful way at the easing of inflationary pressures. The implications of austerity, sacrifice and patience need not be minimized but instead should be recognized as a measure of our commitment in dealing with a most difficult problem. The Federal Reserve for its part will continue to aim monetary policy toward a gradual unwinding of inflation and the maintenance of moderate economic growth.

Chart 1

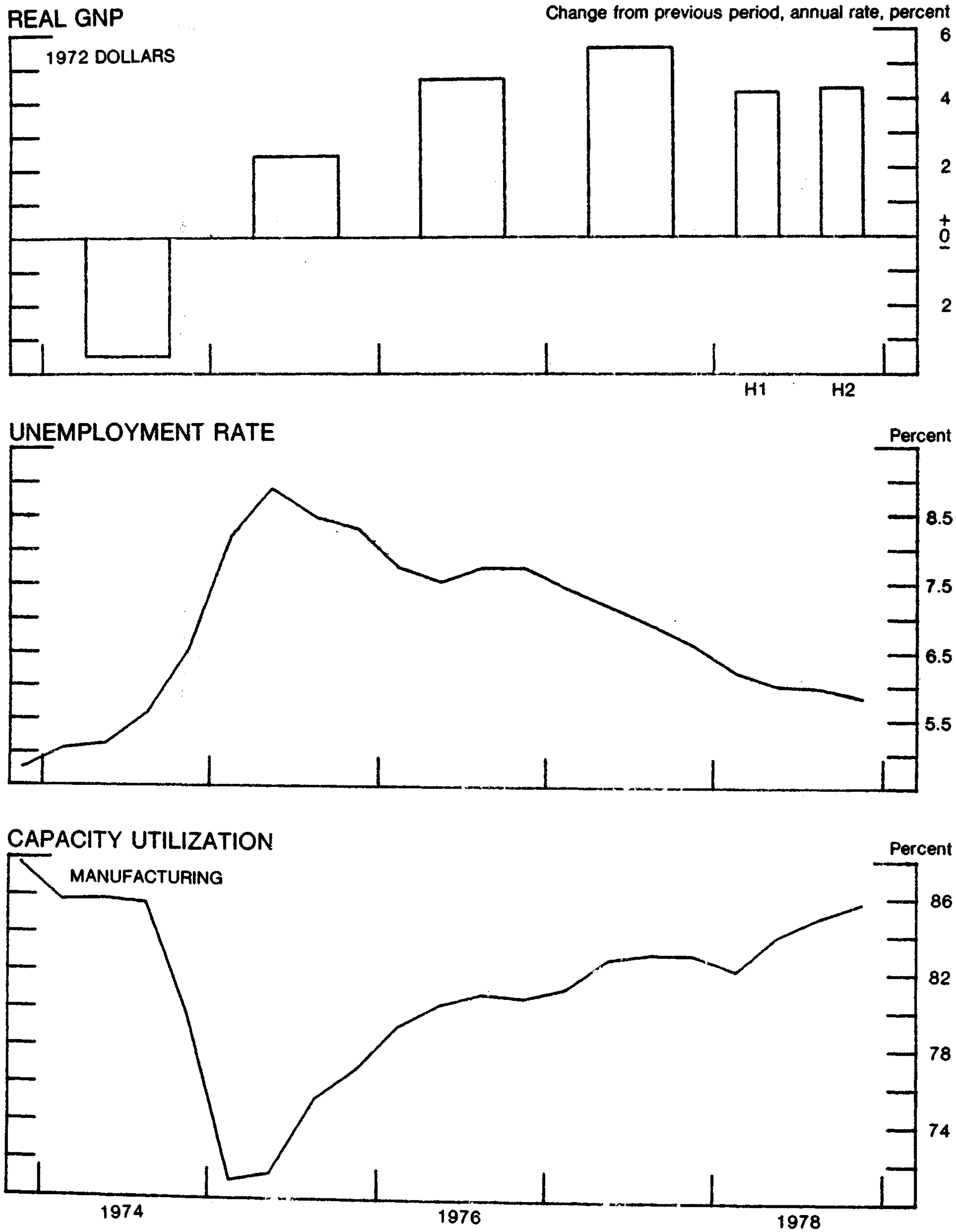
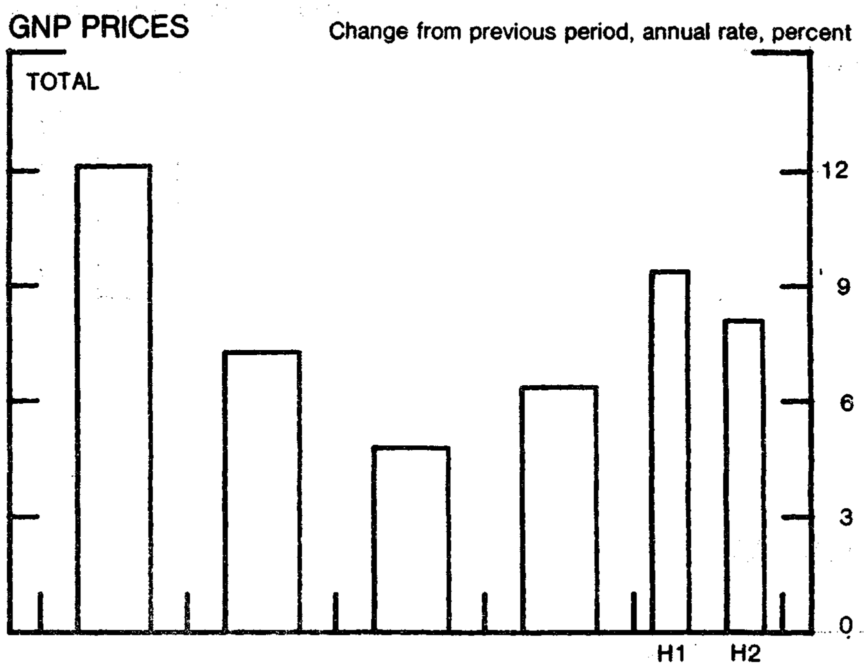

REAL GNP
Change from previous period, annual rate, percent
1972 DOLLARS
6
4
2
+
0
−
2
H1
H2
UNEMPLOYMENT RATE
Percent
8.5
7.5
6.5
5.5
CAPACITY UTILIZATION
Percent
MANUFACTURING
86
82
78
74
1974
1976
1978

Chart 2


GNP PRICES
Change from previous period, annual rate, percent
TOTAL
12
9
6
3
0
H1
H2

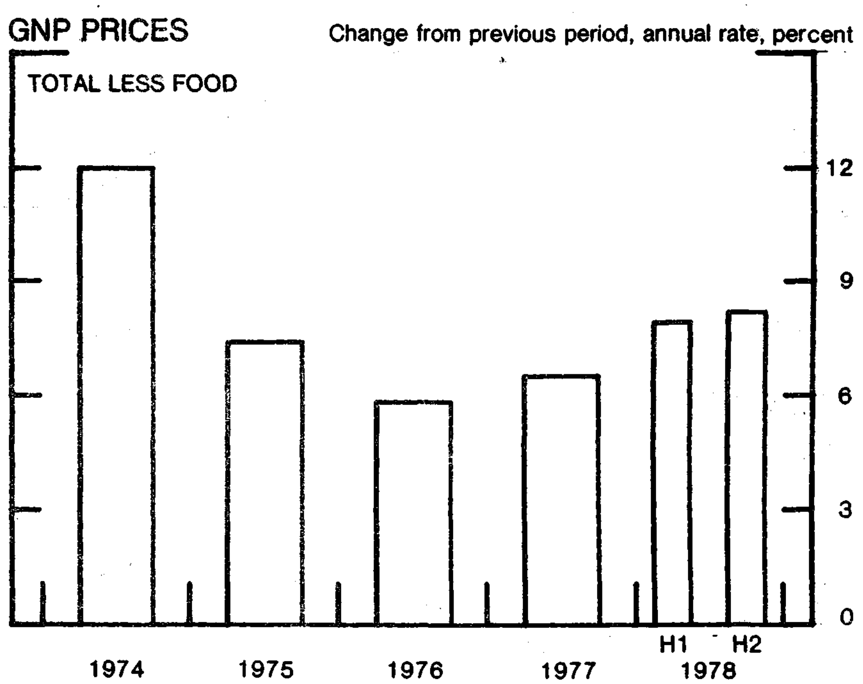

GNP PRICES
Change from previous period, annual rate, percent
TOTAL LESS FOOD
12
9
6
3
0
H1
H2
1974
1975
1976
1977
1978

Chart 3

Current Economic Indicators

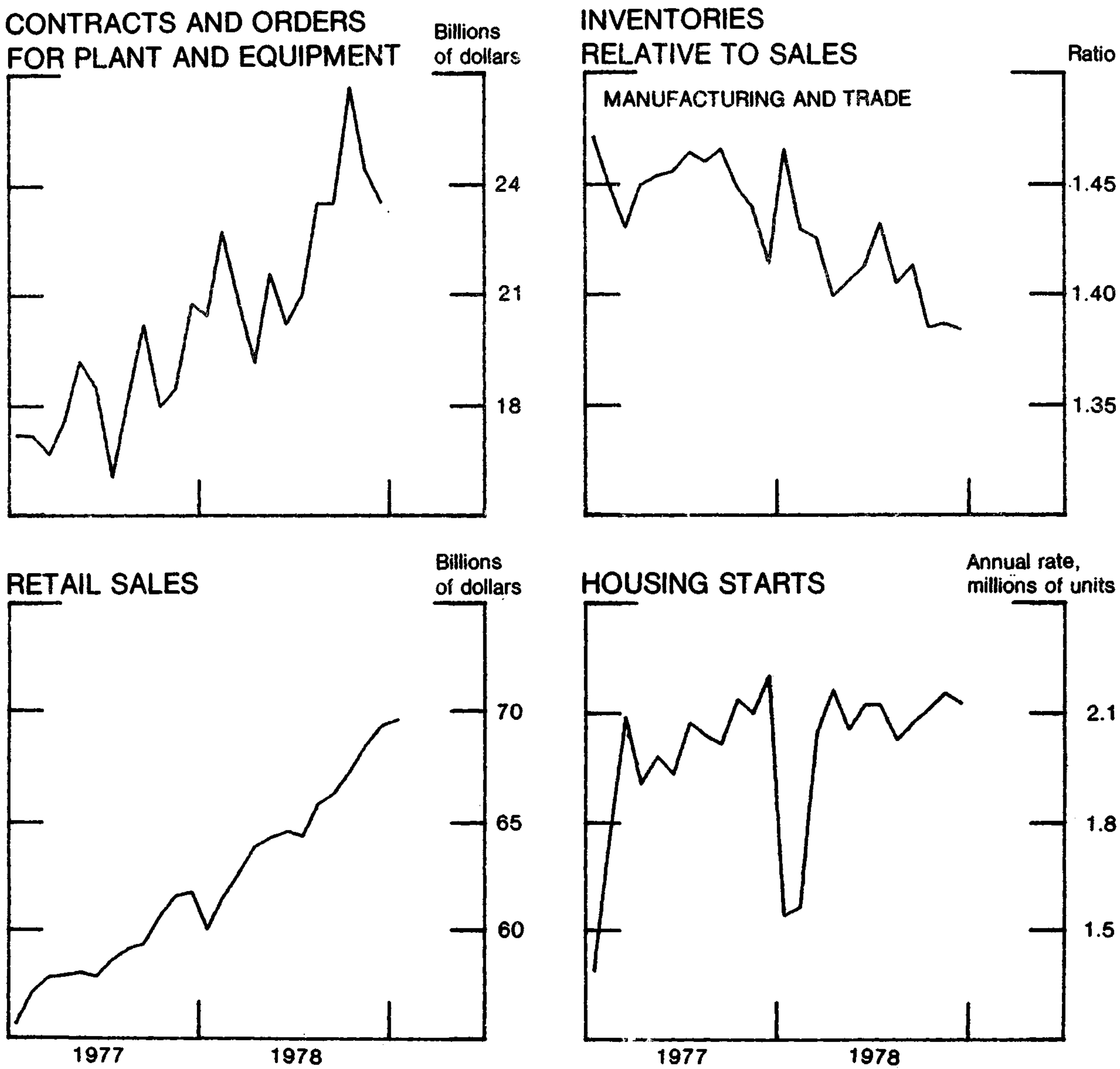


Chart 4

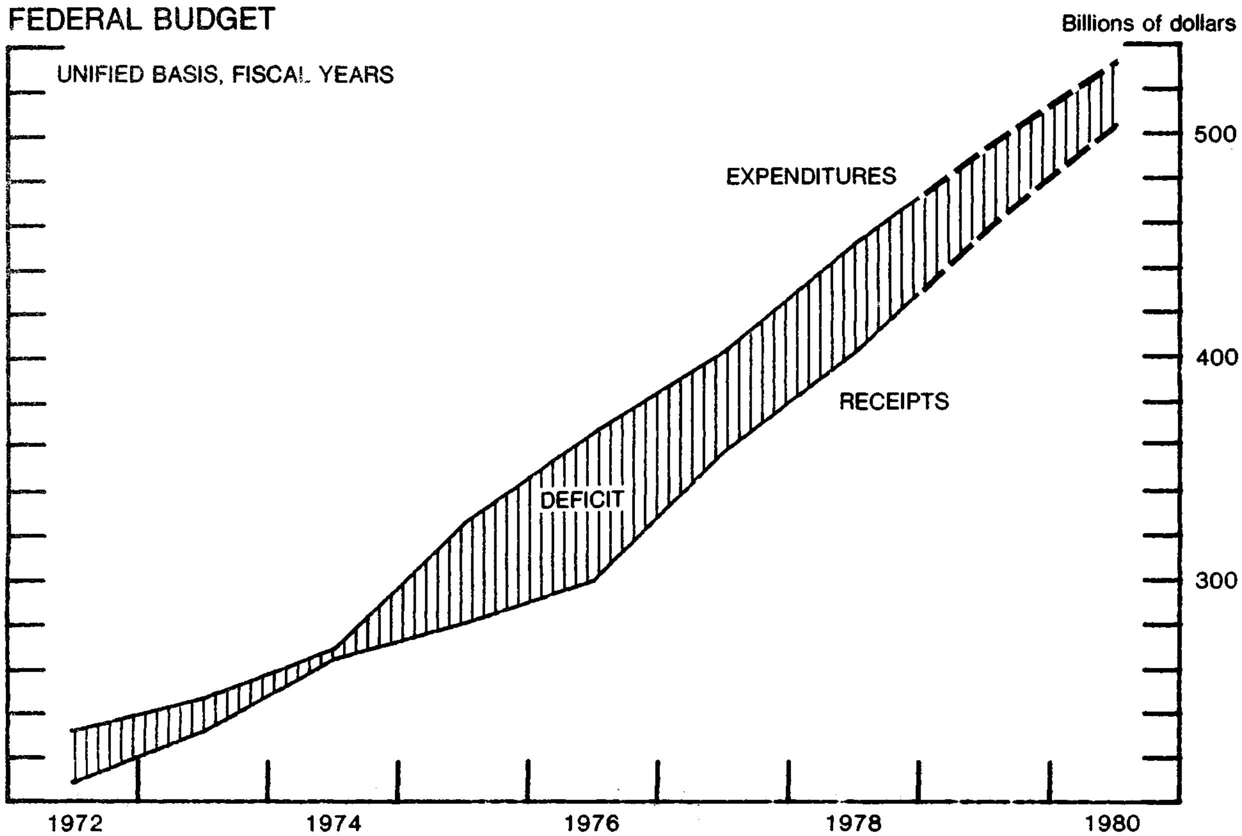

FEDERAL BUDGET
Billions of dollars
UNIFIED BASIS, FISCAL YEARS
EXPENDITURES
DEFICIT
RECEIPTS
500
400
300
1972
1974
1976
1978
1980

Chart 5

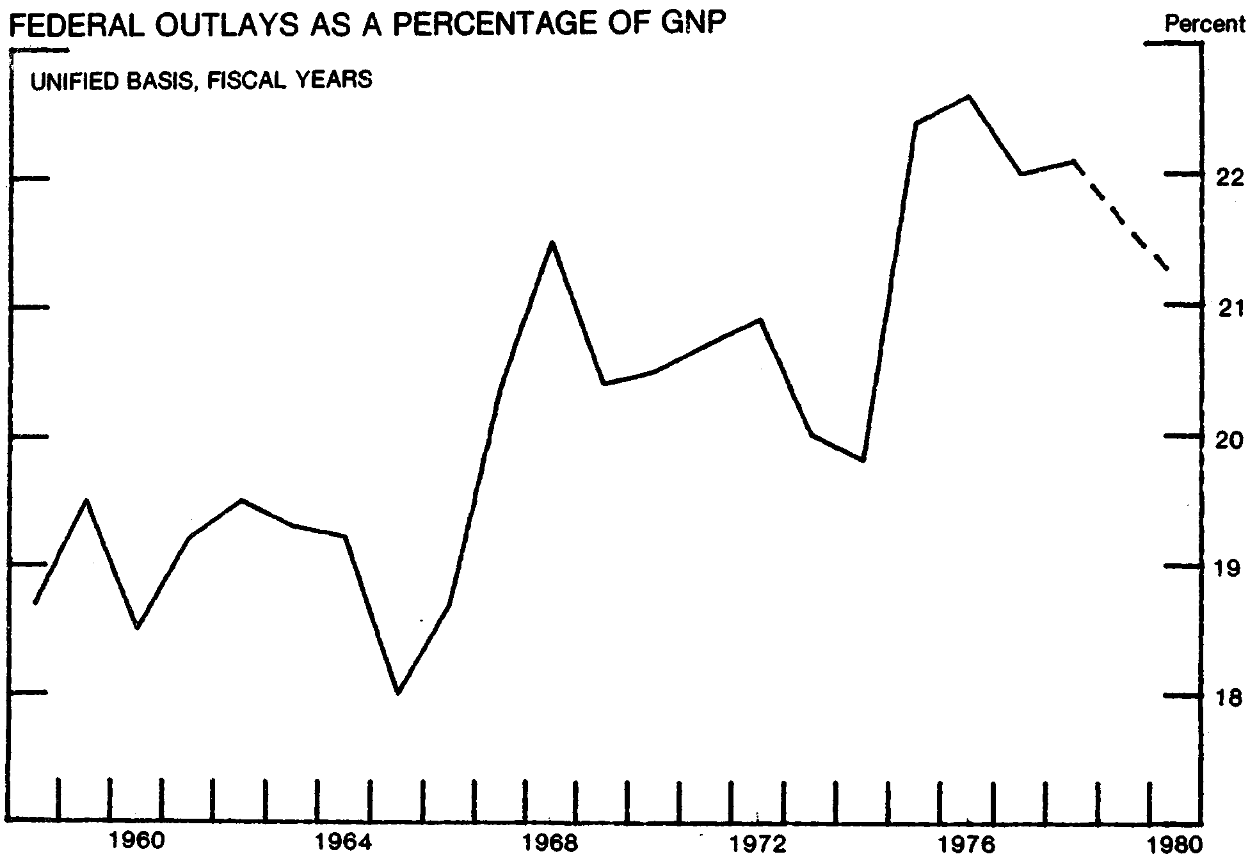
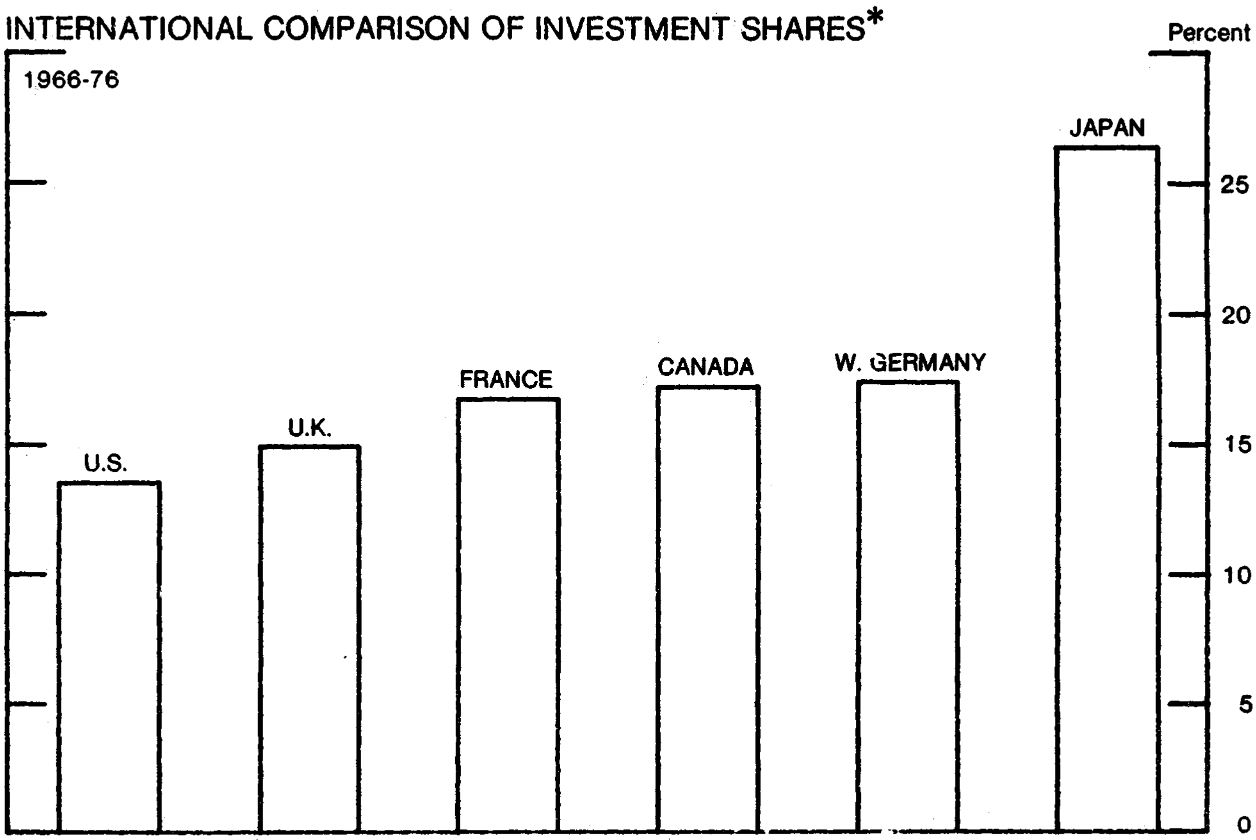

FEDERAL OUTLAYS AS A PERCENTAGE OF GNP
Percent
UNIFIED BASIS, FISCAL YEARS
22
21
20
19
18
1960
1964
1968
1972
1976
1980

Chart 6



* Real nonresidential fixed investment as percent of real gross domestic product; OECD data.
Includes estimate of public sector investment.
Data for France cover the period 1970-75.