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Remarks by
Alan Greenspan
Chairman, Board of Governors of the Federal Reserve System
before
The Concord Coalition
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I am pleased to be with you tonight and honored to receive the Economic Patriot Award. It was especially fitting that you chose to present the first such award to Paul Volcker, who, courageously and successfully, waged a fight against inflation when it was at its most virulent.

Since its founding in 1992, the Concord Coalition has been in the forefront of efforts to educate the public about the importance of reducing the federal budget deficit. Your work has contributed, in no small measure, to the growing public recognition of the issue. The greater public awareness, in turn, is a driving force in the efforts now under way to restore balance to the federal budget.

The progress this year in coming to grips with the budget deficit has been truly extraordinary, and I remain optimistic that the President and the Congress will agree on a program to bring the budget back into balance in the reasonably near future. That sentiment is also evident in the financial markets, where long-term interest rates have fallen this year, in part because of the growing expectation that a credible, multiyear plan for deficit reduction will be adopted. The decline in rates, in turn, has helped stimulate private, interest-sensitive spending--lending support to economic activity. If, for some unforeseen reason, the political process fails, and agreement is not reached, it would signal that the United States is not capable of putting its fiscal house in

order, with serious, adverse consequences for financial markets and economic growth.

It is difficult to overstate the historic importance of the current initiative. Indeed, the intensity of the discussions and controversy surrounding them attest to their seriousness. If the discussions were subdued, I would be concerned that the current effort at deficit reduction was a mirage, as too many in the past turned out to be.

Our economic prospects in coming years will hinge on our ability to increase national saving and to invest that saving wisely. Making a serious commitment to balancing the budget within the next several years is an essential first step--but only a first step. Making good on our commitment by resisting the temptation to depart from that path will be a significant challenge.

For example, the budget plans of both the Congress and the Administration envisage sharp reductions in real discretionary spending in the aggregate over the next several years. However, the specific programmatic changes to implement those reductions must be made in the annual appropriations process, and thus important decisions affecting the years after 1996 will fall to future Congresses and Administrations.

Should the deficit--for whatever reason--not drop as much as projected, additional measures will be required. That prospect has led many to favor the adoption of "look back" mechanisms that would be invoked if certain budget targets were

not satisfied. Such a mechanism, for example, could provide for automatic programmatic cuts in the future if past spending had exceeded its target. Provided the current political support for a balanced budget is sustained--as I suspect it will be--"look back" arrangements could improve the predictability of the outcomes associated with fiscal policy actions.

The current efforts at fiscal restraint should perceptibly lower the track of spending as we enter the twenty-first century. Nonetheless, further actions will have to be taken to address the effects of currently foreseeable long-run demographic changes. As you know, these changes suggest the reemergence of trends toward higher deficits as we move through the first half of the next century. We can, of course, do little to alter the demographic forces in train. We can, however, remove the projected drain on saving and investment that chronic budget deficits will entail. Furthermore, we should think seriously about moving the budget into surplus in the early part of the next century to help foster the accumulation of productive assets to meet the retirement needs of today's working generation.

Timely actions on the budget can help to lift the size of future output above that implied by the current pace of capital formation and the current trend in productivity. Indeed, this is one of the few instances in which we have the luxury of being able to foresee a distant problem that a thoughtful policy response might ameliorate. While implementation of this year's

initiatives clearly will help in lowering the overall current services deficit projected for the first part of the twenty-first century, actions to deal with that deficit more fully will be better designed and far easier to implement the sooner the issue is addressed. Laws enacted with effects delayed for fifteen to twenty years are likely to be decidedly more rationally constructed than when a crisis is much closer at hand. Moreover, putting taxation and benefit structures in place well in advance would enable our citizens to plan better for their futures.

Last month, the finance ministers and central bank governors of the Group of Ten industrial countries released a study by their deputies that examined the relationships among saving, investment, and real interest rates. The study concluded that long-term interest rates in the major industrial countries, adjusted for inflation expectations, have risen by approximately a full percentage point, on average, since the 1960s. It attributed the rise in real rates mainly to a decline in the overall saving rate, which, in turn, was driven largely by substantial increases in budget deficits in virtually all major industrial countries.

This is of particular concern because, over the longer run, upward movements in real interest rates, by suppressing private investment and raising the cost of federal government debt, can add to pressures from the political system toward central bank monetary accommodation and inflation. For sound reasons, markets are skeptical of anti-inflation pledges from

high-deficit countries, and this skepticism elevates long-term rates.

In the shorter run, the ties among deficits, real interest rates, economic activity, and inflation are much looser. In the U.S., for example, in the last decade and a half, inflationary pressures have been reduced despite historic high budget deficits and debt accumulation.

A number of factors have been involved. The key element, of course, has been monetary policy, which gradually suppressed inflationary pressures beginning in 1979. But the appropriate containment policy would have been far more difficult to maintain were it not for the sizable increase in imported saving (reflected in our widening current account deficit), which largely offset the sharp drop in domestic saving that was a consequence of rising budget deficits.

Had the additional foreign source of funds been unavailable, domestic financial strains would surely have been greater and political support for anti-inflation policy far weaker. The ready availability of imported capital has facilitated domestic investment in efficiency-enhancing equipment, particularly in new computer-related technologies. Greater use of these technologies, in turn, has helped to restrain costs and contributed to improved price performance.

However, we cannot depend on imported capital, that is, a current account deficit, to offset low domestic saving indefinitely. As the G-10 study indicates, even though

globalization has led to large capital flows across national boundaries, domestic investment has remained highly dependent on domestic saving. This is likely to continue to be the case. Therefore, unless the budget deficit is brought down before foreign funds become increasingly costly, domestic investment will be impaired, economic growth will slow, and pressures on monetary policy to inflate could reemerge.

I can assure you that the Federal Reserve recognizes that subdued inflation, along with balanced budgets and a further freeing of competitive forces, is a key to the fortunes of the economy as we move into the twenty-first century. To be sure, we, as a society, shall continue for some time to face difficult questions about how to ensure that all segments of our society are afforded opportunities to participate in the greater prosperity. But the improvements in the economic climate that seem to be in train should provide the macro stability and micro incentives needed to foster the investments in human capital that will help redress the imbalances that have concerned all of us in recent years.

Before closing, I would like to address a collateral issue that is related to budget deficits and is often employed, regrettably, as a device to obscure the true extent of deficit spending. I refer to federal government capital budgeting and the debate about whether it would be useful for the unified budget to distinguish between capital expenditures, which support

the creation of assets yielding services over an extended period, and those that are associated with current consumption.

Capital budgeting is a concept that has merit. It can provide useful information about the way a government's activities are affecting overall saving and investment and, more broadly, the economy's longer-run growth prospects. In addition, by highlighting investments that expand our future productive capacity, it can help us make sensible decisions about how the burden of repaying government debt should be spread across generations of taxpayers.

But implementing the concept is fraught with significant difficulties for public policy. Even in the private sector, the distinction between capital and current expenditures has not always been clear. For example, many items, such as R&D, some corporate software, and some personnel technical training, are routinely expensed. However, market prices suggest that they are income-earning and thus should be capitalized and added to the balance sheet in support of debt. As I indicated in a speech before the Economic Club of Chicago a couple of weeks ago, the rising market-to-book value of corporate equity is probably indicative, in part, of an undervaluation of private capital investment outlays and, incidentally, of the GDP.

In the private sector, there are at least some market signals that are useful in gauging the value of corporate assets. Unfortunately, in the public sector, the market approach is probably infeasible. In concept, one might think that financial

markets would value the debts of the government more highly--that is, require lower interest rates--if they were incurred in the creation of a national asset base that expands the economy's potential to produce output, income, and tax revenues--that is, if they create the wherewithal for repayment. Regrettably, however, the complexity of filtering out the various factors that determine the rate of interest the Treasury has to pay makes such an evaluation exceptionally difficult, and any signals we could extract are unlikely to be very useful.

Under the circumstances, the distinctions among types of federal spending are fuzzy, and decisions about classification are likely to be somewhat arbitrary. For example, one might argue that federal outlays on education increase skills, enhance the income-earning capabilities of our work force, and hence produce federal taxes as a measured return on the education outlay. Or, still a step further, our military spending (I do not limit it to equipment) enhances the security of our nation and as a consequence protects our private capital stock, both here and abroad. Is this not a real flow of insurance services comparable to the income produced from private R&D, for example? Where should the line be drawn?

I am also concerned that the temptation to designate an expenditure as a capital outlay would be hard to resist because such a designation would remove it from the restraint that would be imposed on other spending. Simply shifting some outlays to a capital budget might also create the illusion of a move toward

surplus in the current budget that could lull us into a complacency about our fiscal affairs that we might live to regret. Accordingly, unless, and until, the practical issues are resolved, it would not, in my judgment, be prudent to create a capital budget for Treasury financing.

Finally, I want to conclude by commending the Concord Coalition for its work over the past few years. You should take great pride in the heightened attention to the federal budget this year. But much remains to be done, and I expect your wisdom, insights, and determination to remain a force in addressing the fiscal challenges in the years ahead.