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Statement of

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on the Budget

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Mr Chairman and members of the Committee, in just a few weeks, the Federal Reserve Board will submit its semiannual report on monetary policy to the Congress. That report, and my accompanying testimony, will give a detailed assessment of the outlook for the U S economy and the implications for monetary policy. This morning, I would like to direct most of my comments to the fiscal situation. But let me begin by offering a few observations about the current direction of the economy.

First, it is clear that the U S economy has been exceptionally healthy, with robust gains in output, employment, and income. At the same time, inflation has remained low--indeed, declining by most measures--over the past year.

Second, to date, we have as yet experienced only the peripheral winds of the Asian crisis. But before spring is over, the abrupt current-account adjustments that financial difficulties are forcing upon several of our Asian trading partners will be showing through here in reductions in demand for our exports and intensified competition from imports. All of this suggests that the growth of economic activity in this country will moderate from the recent brisk pace.

Third, as I've noted previously, such a moderation would appear helpful at this juncture. The growth of output has caused employment to rise much faster than the working-age population and there are limits to how far this can go. Pressures in the labor market likely contributed to the acceleration of wages in recent months. Since price inflation has been minimal and domestic profit margins firm, productivity appears to have accelerated sufficiently last year to damp increases in unit labor costs. How long that pattern can continue is still an unresolved issue. The likelihood that we shall be seeing some lower prices on imported goods as a result of the difficulties in Asia may afford some breathing room from inflation pressures. But they will

not permanently suppress the risks inherent in tightened labor markets. Conversely, a continuation of the Asian crisis should give us pause in assuming that our economy will remain robust indefinitely. As a consequence, we must be vigilant to the reemergence of destabilizing influences--both higher inflation, and shortfalls in demand and decreases in some prices that would press the disinflation process too far, too fast.

One very favorable aspect of our economic performance over the past few years has been the remarkable improvement in the federal budget picture. The deficit dropped to its lowest level in more than two decades in fiscal 1997, and yesterday the Congressional Budget Office released projections that show the budget remaining essentially in balance over the next few years, moving to annual surpluses equal to 1 percent of GDP by the middle of the next decade. The reduction in federal borrowing to date and in prospect is already paying off for the U.S. economy by helping hold down long-term interest rates and, in turn, providing support to private capital spending and other interest-sensitive outlays.

But much hard work remains to be done to ensure that the projected surpluses actually materialize and that we remain on track to address our longer-run fiscal and demographic challenges. The CBO projections provide a good starting point. They are based on sensible economic and technical assumptions and thus offer a reasonable indication of how the budget is likely to evolve over the next 10 years if economic conditions remain favorable and current budgetary policies remain in place. But, as CBO highlights in its latest report, such forecasts are subject to considerable error. Indeed, as recently as last winter, when fiscal 1997 was already well under way, both CBO and OMB were still overestimating that year's deficit by more than \$100 billion.

In the case of CBO, about two-thirds of the error was in receipts, including nearly \$50 billion more tax receipts than would have been expected based on the actual behavior of income as measured in the national income and product accounts. This overage helped lift the receipts share of GDP to an historical high. Such "tax surprises" are nothing new--in fact, in the early 1990s, growth of receipts fell well short of expectations based on the trends in aggregate income and the tax laws then in place. And, even after the fact, our knowledge about the sources of such surprises has been limited. Thus, we cannot rule out the possibility that the forces behind last year's tax surge will prove transitory and dissipate more rapidly than CBO has assumed, implying lower receipts and renewed deficits for the years ahead. Indeed, all else equal, had the surprise fallen on the other side--downward instead of upward--we would be looking at non-trivial budget deficits at least through the beginning of the coming decade.

Moreover, the CBO projection assumes that discretionary spending will be held to the statutory caps, which allow almost no growth in nominal outlays through fiscal 2002. Given the declining support for further reductions in defense spending, keeping overall discretionary spending within the caps is likely to require sizable, but as yet unspecified, real declines in nondefense programs from current levels. Not surprisingly, many observers are skeptical that the caps will hold, and battles over appropriations in coming years may well expose deep divisions that could make the realization of the budget projections less likely. In addition, although last year's legislation cut medicare spending substantially, experience has highlighted the difficulty of controlling this program, raising the possibility that the savings will not be so great as anticipated--especially if resistance develops among beneficiaries or providers.

Uncertainties such as these argue for caution as you begin work on the 1999 budget. We

have no guarantee that the projected surpluses will actually materialize. An even more important consideration, though, is the need to address the erosion of the budget after the next decade, a task that will become increasingly difficult the longer it is postponed. The favorable budget picture over the next decade, unless steps are taken, will almost inevitably turn to large and sustained deficits as the baby boom generation moves into retirement, putting massive strains on the social security and medicare programs.

Indeed, especially in light of these inexorable demographic trends, I have always emphasized that we should be aiming for budgetary surpluses and using the proceeds to retire outstanding federal debt. This would put further downward pressure on long-term interest rates, which would enhance private capital investment, labor productivity, and economic growth.

The outpouring of proposals for using the anticipated surplus does not bode well for the prospect of maintaining fiscal discipline. In recent years the President and the Congress have been quite successful, contrary to expectations, in placing, and especially holding, caps on discretionary spending. More recently, they have started to confront the budget implications of the surge in retirements that is only a decade away. We must not allow the recent good news on the budget to lull us into letting down our guard. Although many of the individual budget proposals may have merit, they must be considered in the context of a responsible budget strategy for the longer run.

Over the decades our budgetary processes have been biased toward deficit spending. Indeed, those processes are strewn with initiatives that had only a small projected budgetary cost, but produced a sizable drain on the Treasury's coffers over time. As you are well aware, programs can be easy to initiate or expand, but extraordinarily difficult to trim or shut down once

a constituency develops that has a stake in maintaining the status quo

In closing, I want to commend Chairman Domenici and the committee for your insistence on fiscal responsibility and for years of persistent effort. Your work has contributed importantly to shrinking the budget deficit and bringing surpluses within sight. These projections of surpluses, which are based on an extrapolation of steady economic growth and subdued inflation over the coming years, implicitly assume that monetary and fiscal policymakers will remain attentive to potential sources of instability. If this is the scenario that, in fact, unfolds and the budget moves into surplus within the next few years, the increase in national saving will pay off handsomely in preparing our economy and our budget for the challenges of the twenty-first century.