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Statement by

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Board of Governors of the Federal Reserve System

before the

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Mr. Chairman and members of the Committee, just last week I presented the Federal Reserve's semiannual report on economic conditions and the conduct of monetary policy. This morning, I will briefly review some aspects of that outlook before I turn to a more detailed discussion of coming budgetary challenges.

The exemplary performance of the U.S. economy in 1997 will be hard to match. Last year's combination of robust expansion of activity, healthy creation of new jobs, and a decline in inflation generated widespread benefits for our citizens. Many of those benefits have the promise to be long-lived: Our nation has been experiencing a higher growth rate of productivity--output per hour worked--in recent years, which is the ultimate source of rising standards of living.

There can be no doubt that domestic demand retained some of its considerable momentum going into this year. Production and employment have been on a strong uptrend in recent months. Confident households, enjoying gains in income and wealth and benefitting from the reductions in intermediate- and longer-term interest rates to date, should continue to increase their spending. Firms should find financing available on relatively attractive terms to fund profitable opportunities to enhance efficiency by investing in new capital equipment. By itself, this strength in spending would seem to presage intensifying pressures in labor markets and on prices. Yet, the outlook for total spending on goods and services produced in the United States is less assured of late because of storm clouds massing over the Western Pacific and heading our way.

With the crisis curtailing the financing available in foreign currencies, many Asian economies have had no choice but to cut back their imports sharply from the

United States and elsewhere, a situation made worse by disruptions to their financial systems and economies more generally. American exports should be held down further by the appreciation of the dollar, which will make the prices of competing goods produced abroad more attractive, just as foreign-produced goods will be relatively more attractive to buyers here at home. As a result, we can expect a worsening net export position to exert a discernible drag on total output in the United States and the dollar prices of our non-oil imports to extend their recent declines. These lower import prices are apparently already making domestic producers hesitant to raise their own prices for fear of losing market share, further contributing to the restraint on overall prices.

The key question going forward is whether the restraint building from the turmoil in Asia will be sufficient to check inflationary tendencies that might otherwise result from continued strength of domestic spending and tightening labor markets. The depth of the adjustment abroad will depend on the extent of weakness in the financial sectors of Asian economies and the speed with which structural inefficiencies in the financial and nonfinancial sectors of those economies are corrected. If, as we suspect, the restraint coming from Asia is sufficient to bring the demand for American labor back into line with the growth of the working-age population desirous of working, labor markets will remain unusually tight, but any intensification of inflation should be delayed, very gradual, and readily reversible. However, we cannot rule out two other, more worrisome possibilities. On the one hand, should the momentum to domestic spending not be offset significantly by

Asian or other developments, the U.S. economy would be on a track along which spending could press too strongly against available resources to be consistent with contained inflation. On the other, we also need to be alert to the possibility that the forces from Asia might damp activity and prices by more than is desirable by exerting a particularly forceful drag on the volume of net exports and the prices of imports.

The robust economy has facilitated the efforts of the Congress and the Administration to restore balance in the unified federal budget. The deficit dropped to its lowest level in more than two decades in fiscal 1997, and both the Administration and the Congressional Budget Office now expect the budget to remain essentially in balance over the next few years before moving to moderate surpluses by the middle of the next decade. I should caution, though, that while receipt growth remained robust through January, the prospects for fiscal 1998 as a whole remain uncertain until we have a tally of the final payments that will be included in the April's tax returns.

As I have indicated to the Congress on numerous occasions, putting the unified budget into significant surplus would be the surest and most direct way of increasing national saving. In turn, higher national saving, by promoting lower real long-term interest rates, helps spur spending to outfit American firms and their workers with the modern equipment they need to compete successfully on world markets. We have seen a partial down payment of the benefits of better budget balance already: It seems reasonable to assume that the decline in longer-term

Treasury yields last year owed, in part, to reduced competition--current and prospective--from the federal government for scarce private saving.

But much hard work remains to be done to ensure that these projected surpluses actually materialize and that the appropriate budgetary strategy is in place to deal with the effects on federal entitlement spending of the looming shift in the nation's retirement demographics. The baseline projections from OMB and CBO provide a good starting point for assessing the budget outlook over the medium term: They are based on sensible economic and technical assumptions and thus offer a reasonable indication of how the budget is likely to evolve if economic conditions remain favorable and current budgetary policies remain in place. However, the experience of the past few years amply demonstrates that such forecasts are subject to considerable error. For evidence on that score, we need only look back to last winter. Even with fiscal 1997 already well under way, both CBO and OMB were overestimating that year's deficit by about $100 billion.

In retrospect, much of the error in last winter's deficit estimates fell on the inflow side, largely reflecting a surge in tax receipts that far exceeded estimates. This "tax surprise", which helped lift the receipts share of GDP to an historical high, was not a new phenomenon. In the early 1990s, growth of receipts consistently fell short of expectations based on the trends in aggregate income and the tax laws then in place. Even after the fact, our knowledge about the sources of such surprises has not always been definitive. As a result, we must remain cautious about extrapolating recent favorable tax inflows into the future. We cannot rule out the possibility that the next few years will see a more rapid dissipation of the strength in receipts than either OMB and CBO have assumed, implying renewed deficits. Indeed, all else equal, had the 1997 surprise fallen on the other side--downward instead of upward--we would be confronted by non-trivial budget deficits at least through the beginning of the coming decade.

Moreover, the baseline projections assume 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, 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.

These uncertainties underscore the need for caution as you move ahead on your work on the 1999 budget. There is no guarantee that projected surpluses over the next few years will actually materialize. However, we can be more certain that, absent action, the budgetary position will erode after the next decade as the baby boom generation moves into retirement, putting massive strains on the social security and medicare programs. Without question, the task of stemming that erosion will become increasingly difficult the longer it is postponed. 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. In that regard, one measure of how much progress has been made in dealing with the nation's fiscal affairs is that serious discussion of such paydowns has begun to surface. Working down the stock of the federal debt would put further downward pressure on long-term interest rates, which would enhance private capital investment, labor productivity, and economic growth, preparing us better to confront the looming changes in retirement demographics.

Over the decades, our budgetary processes have been biased toward deficit spending. Indeed, those processes are strewn with initiatives that were viewed as having only a small projected budgetary cost at inception, but which 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 them. Thus far, 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 will occur early in the next century. But the good news of late on the budget has unleashed an outpouring of proposals that, if adopted, do not bode well for the maintenance of fiscal discipline. Although many of the individual budget proposals may have merit, they must be considered only in the context of a responsible budget strategy for the longer run.

In closing, I want to commend Chairman Kasich and the members of the committee for your insistence on fiscal responsibility and persistent efforts to bring the budget under control. The shrinking budget deficit and the prospect of surplus stand as testimony to your endeavors. But we must remember that projections of surpluses are based on an extrapolation of steady economic growth and subdued inflation in coming years. Achieving such a performance in these uncertain times, with the U.S. economy now subject to a fine balance of powerful forces of expansion and restraint, will provide policymakers with a considerable challenge. And, on your part, not succumbing to the temptation to commit prematurely future surpluses that exist only on paper, while, in addition, addressing the adverse effects of ongoing demographic changes to the budget over the longer run, will not be easy. However, if we meet these challenges, the increase in national saving and investment will almost surely pay off handsomely in the form of a more rapidly expanding standard of living for all Americans.