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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

House of Representatives

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I appreciate the opportunity to appear before this Committee today. As you know, the Federal Reserve submitted its semi-annual monetary policy report to the Congress last week. That report, which we have distributed to you, describes in detail our plans for monetary policy, including the Federal Open Market Committee's ranges for growth of money and credit. A copy of my statement to the Banking Committees has also been provided. My prepared remarks this morning will be brief and confined to more general considerations of domestic and international economic policies within the context of recent and prospective developments.

The past year was one of further progress in the nation's economy. Although the growth of domestic production slowed last year, the rise in output still was sufficient to generate 3 million new payroll jobs and to reduce the unemployment rate significantly further. Moreover, growth was sustained consistent with maintaining the progress that had been achieved on the inflation front.

As we move into 1986, the prospects for extending the economic advances of the past year appear, by and large, to be good. The latest reports on employment, industrial production and housing activity show further increases around the turn of the year. Confidence appears well maintained, cost increases have been restrained, and interest rates, particularly in the long-term area, have moved significantly lower. The sharp recent declines in the oil price, given the weight of energy in the economy, appear to assure favorable price performance in the months immediately ahead.

In this context, the Federal Open Market Committee at its meeting earlier this month reaffirmed the tentative ranges it had established last July for the broader monetary and credit aggregates, M2 and M3. For M1, the target range was widened to take account of the greater uncertainty surrounding the behavior of this aggregate, but the mid-point of the range was the same as tentatively agreed six months ago.

In deciding upon these ranges, the Committee understood that particular uncertainty had surrounded the recent behavior of M1 and its velocity. Consequently, evaluation of the significance of changes in M1 will continue to be made in light of the trend in the other monetary aggregates. Moreover, evaluation of the outlook for business activity and prices, as well as conditions in domestic and international markets will, as in the past, contribute to the operational judgments of the Committee in determining the proper degree of pressure on reserve positions.

Consistent with this approach and the ranges set out, members of the Federal Reserve Board and the Reserve Bank Presidents expect that the economy will grow somewhat faster this year than in 1985. Views on the outlook for inflation were more diverse; some expected additional slowing, while others anticipated a moderate pickup from the 1985 inflation rate. The "central tendency" of the projections of real GNP and inflation for 1986 generally is a little lower than the Administration's forecasts of about 4 percent each, and is closer to the growth projections of the Congressional Budget Office. However, the differences are not large. Indeed, the full range of expectations expressed by Board Members and Bank Presidents does encompass both the Administration's and the CBO's figures.

Although prospects for economic performance in 1986 appear favorable at this time, there are inevitably some important uncertainties and points of strain. The two major, and interrelated, imbalances that I have stressed so often in the past -- the enormous trade and fiscal deficits -- remain. But there is a potentially crucial difference from the situation a year ago. The actions by the Congress and the Administration on the budget carry the clear promise of progress toward better budgetary balance in the years ahead. At the same time, a substantial adjustment in exchange rates has occurred during the past twelve months, improving the competitive position of American firms and over time contributing to a reduction in our trade deficit.

At the same time, we have to understand that both developments -- substantially reduced budget and trade deficits -- will require hard and persistent efforts over a considerable period, measured in years. In the meantime, financing both deficits will require a large continuing net inflow of funds from abroad. That is a major reason we must keep in mind the need to maintain confidence in our currency and the potentially inflationary effects of rapid depreciation. A clear appreciation in the marketplace of improved prospects for the deficit are a major element of protection against those risks, and that is why I welcome the efforts made by the Administration, the Congress, and this Committee to place the budget deficit on a declining trend.

I recognize that reducing the deficit requires difficult decisions. From my particular position, I will refrain from responding to your invitation as to where specific budgetary cuts should be made; that process involves intensely political choices entirely in the domain of the Congress and the Administration.

As I have indicated many times before, from a purely economic perspective, the performance of the economy over time in terms of efficiency and incentives tends to be better served by approaching deficit-cutting from the spending side rather than from the tax side. Only if sufficient spending cuts cannot in fact be enacted to place the deficit on a solidly declining trend does the question of substantial action on the revenue side become relevant.

The potential benefits of smaller budget deficits already can be seen in improved market sentiment. As you know, both intermediate- and long-term interest rates have declined sharply in recent months, interest rates generally are at the lowest level since 1979, and the stock market has continued to set new records. Although other factors have played a role in these developments -- for example, lower oil prices -- the prospects for budgetary restraint clearly have been a critical factor. The effects of lower interest rates are beginning to be felt in housing activity, where sales of single-family homes are at a six-year high and housing starts are up most recently. Lower rates and higher stock prices should assist other private investment decisions as well.

In the short run, as they become effective, deficit reduction actions, taking account of their direct impact, restrain the growth of income and potential economic activity. Those direct effects may, of course, be balanced by other economic developments, including in part the beneficial effects of lower interest rates, stimulated by the budget reductions themselves. The precise balance of these forces is hard to foresee -- at present, for instance, the decline in oil prices itself is releasing purchasing power to American consumers.

The balance of these forces, currently and prospectively, is, of course, an important element in the judgments that we must make on monetary policy, but I know of no way to express realistically a kind of mathematical "tradeoff" in light of all the cross-currents in the economy.

Trade and budget deficits are not the only imbalances that pose uncertainties for the economic outlook. Pervasive pressures remain in much of the agricultural sector, and key manufacturing industries continue to face strong competition from foreign producers. In financial markets, a number of institutions have had to cope with loan problems associated with sectoral economic pressures, the large debt burdens of some borrowers at home or abroad, and the disinflationary process. Beyond implications for monetary policy, this poses challenges for banking supervisors and other public policies; the recently enacted Farm Bill, for instance, will provide substantial elements of support for the agricultural sector. As I noted earlier, the decline in the foreign exchange value of the dollar will help bring about an environment in which U.S. producers will be able to compete more effectively in world markets. And the efforts of many depository institutions to bolster capital and reserves should help these institutions to cope with financial strain.

It would be foolish, of course, to think that we have prepared in advance for every eventuality. Indeed, a number of questions remain, including the strength of economic expansion abroad, the impact of a declining dollar on U.S. inflation, and the effect of lower oil prices on the financial health of domestic energy producers and of a number of oil-exporting developing countries. But adverse shocks in these areas, or others, should be manageable if there is cooperative effort among all involved parties here and abroad.

Mr. Chairman, you asked me to comment on any areas of federal spending in which across-the-board spending cuts could have disruptive effects in financial markets. Given our particular responsibilities, I must in that connection note that the ability of the Federal Reserve and other bank regulatory agencies to add resources to our supervisory efforts will inevitably be impacted. While voluntarily complying with the spirit of Gramm-Rudman-Hollings legislation, we intend to limit the impact of cuts in that high priority area as much as feasible. Our sister agencies, in some instances, may have less flexibility.

This strikes me as one example of the need to make the hard budget choices as a matter of considered national priority rather than falling back on inevitably arbitrary "across-the-board" sequestering procedures, however important the latter may be in encouraging discipline.

Let me conclude my remarks by noting that we at the Federal Reserve share common goals with the Congress and the Administration -- maintaining sustainable growth of economic activity in a context of greater price stability. Substantial progress has been made over the past year. We also have to recognize that we still have some distance to travel, and that indeed the effort is never ending. But we have come too far, and the stakes are too high, to fail to meet the challenge now.

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