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STATEMENT BY

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Under the Congressional budget procedures adopted in 1974, increases in the Federal debt ceiling have become essentially a reflection of the Federal budget totals Congress sets with the help of its new budget committees. Debt ceiling hearings, nevertheless, provide an opportunity for review and reassessment of the broader economic implications of a large and rapidly growing Federal debt. My testimony today will, therefore, focus as requested on some of the financial implications of an expanding public debt.

The Federal budget document recently sent to Congress provides projections of expected increases in the Federal debt subject to ceiling, along with estimates of the likely dimensions of needed changes in the debt ceiling itself. While the outstanding Federal debt is expected to remain below the present temporary ceiling of $752 billion during the next two months, this temporary leeway expires on March 31. Since the permanent debt ceiling is still set at $400 billion, a new temporary ceiling will obviously be needed by that date.

The Budget Document estimates that a new temporary ceiling of $781 billion will be needed to accommodate prospective Federal borrowing requirements through the end of the current fiscal year. Of this $29 billion increase, about $10 billion is needed to cover expected growth in agency holdings of Government debt, chiefly to fund future Civil Service retirement liabilities and unemployment compensation. A further increase in the ceiling to $871 billion is estimated to be needed to cover requirements through fiscal 1979, with about $15 billion of the $90 billion increase allotted to agency fund growth.

The projected need for a higher debt ceiling also reflects the Administration's estimate that the Treasury will have to borrow $66 billion from the public during the current fiscal year, and then another $73 billion during fiscal 1979. These estimates include borrowing to finance so-called "off-budget" needs as well as regular budget requirements. Since "off-budget" needs add to Federal demands on financial markets, a borrowing figure that covers both types of operations provides a more comprehensive measure of the financial pressures being exerted by Federal requirements. It should be noted that the $66 and $73 billion figures relate only to net cash borrowing from the public. Gross borrowing to refinance public holdings of maturing Federal debt will be several times the volume of net borrowing.

Successive fiscal-year cash borrowing totals of $66 and $73 billion are obviously large. However, their likely impact on conditions in financial markets will depend on the aggregate volume of savings available in the economy and the accumulated demand for funds from other types of borrowers. Moreover, the significance of given absolute dollar totals of Federal deficit financing must be kept in perspective, by also considering the growth in the overall level of economic activity.

In fiscal Year 1976, net Federal borrowing from the public totaled over $83 billion, substantially more than the annual figures now being projected for the current fiscal year and for fiscal 1979. However, with the economy in fiscal 1976 still in the early stages of recovery from the serious 1974-75 recession, demands for funds from other nonfinancial sectors were relatively moderate. Businesses were making sizable net repayments of short-term loans at commercial banks, and demands for funds to finance multi-family housing and commercial properties remained slack. As a result, net borrowing by the Federal government and other nonfinancial sectors, combined, amounted to about 15 per cent of GNP--a reasonable total under the circumstances of the recovery taking place that year. Moreover, with credit demands moderate, commercial banks and other institutions were still actively rebuilding liquidity in the aftermath of the 1973-74 financial strains. Consequently, there was a strong demand for U. S. Government securities, and the unusually large net Federal borrowing need was readily accommodated at declining interest rates.

In the fiscal year 1977--which ended last September--net funds raised by sectors other than the Federal Government were more than $100 billion above the fiscal 1976 level. Even though Federal cash borrowing was about $30 billion lower, total borrowing by all sectors still showed a large increase and rose as a percentage of GNP. In bond and mortgage markets financing outside the Federal sector rose by roughly 60 per cent; consumer credit expanded sharply; and bank lending to businesses showed a marked recovery from the earlier cyclical slackness.

As their customers' demands for loans expanded, commercial banks sharply curtailed their acquisitions of Treasury securities; then during the final quarter of the fiscal year they became sizable net sellers of such issues. Nonfinancial corporations were also sellers of Treasury debt on balance over the year as a whole.

Thus, changes on both the demand and supply sides of financial markets contributed to upward pressures on market interest rates during the latter half of fiscal 1977 as the economy continued to expand. Short-term interest rates rose the most, but some increases also developed in note and bond markets, particularly those for intermediate-term Treasury debt which absorbed a sizable volume of new offerings. Open-market operations undertaken by the Federal Reserve to counter the excessively rapid monetary growth that developed in the April and July quarters of 1977 contributed to the rise in short-term rates, although reserves available to the banking system expanded significantly during fiscal 1977 after remaining essentially unchanged in fiscal 1976.

Since the end of fiscal 1977, the current and prospective near-term volume of Federal deficit financing has expanded considerably. Pressures on Federal financing costs stemming from this expanded borrowing might have been greater had it not been for two special types of demands for Treasury debt that became particularly strong in this period. Foreign investors--chiefly central banks and other official institutions--invested a substantial part of their sharply increased holdings of U. S. dollars in Treasury debt. Also, State and local governments continued to acquire a large volume of special Treasury arbitrage bonds, and thus limited the volume of new debt the Treasury had to sell to other investors.

The Treasury has projected net Federal cash needs in the current quarter not too different from the large volume borrowed in the January quarter of fiscal 1976. During the May-June period, however, it expects the weight of Federal borrowing on fianncial markets to slacken--with some seasonal debt repayment. During the July-September quarter, although the Treasury is again likely to face a sizable deficit, net borrowing will probably be less than in the current quarter and possibly little different from the comparable perod a year ago.

In general, the net impact of the Treasury's future borrowing requirements on financial markets will depend in large measure on the weight of other credit demands at the time. If rising Federal deficits occur in combination with a general strengthening of other demands, this might very well lead to further upward pressure on interest rates, particularly if inflationary increases in the monetary aggregates are to be avoided. In order to encourage the capital spending by businesses that is needed to maintain our nation's economic growth and international competitiveness, it is, therefore, important to ensure that the Federal government does not unduly impinge on the financial and real resources that need to be channeled into business expansion.

Before concluding, Mr. Chairman, I would like to offer two comments of a strictly operational character. First, I think the early timing of this hearing in relation to the expiration date of the debt ceiling is all to the good, since it should help to avoid the unfortunate disruption of efficient debt management that invariably develops when the ceiling reverts back to its permanent level--even for a few days. Second, the Federal Reserve hopes that your actions will continue to provide the Treasury with the requisite statutory flexibility to place new debt in whatever maturity sector of the market will best implement its policy goals.