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Statement by

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I appreciate the opportunity to present the views of the Federal Reserve Board on S. 50, the "Full Employment and Balanced Growth Act of 1976." This bill would amend the Employment Act of 1946, which requires the Federal government to utilize all of its resources in order to foster conditions that "promote maximum employment, production and purchasing power." The Federal Reserve Board fully recognizes its responsibility under the 1946 Act and has reported regularly to Congress on its efforts to further the objectives of the law. The central question facing Congress as it considers S. 50 is whether or not the proposed amendments will help advance the goals of the original Act. I am sorry to say that we do not believe they will. The bill is both too rigid and too inflationary and, on balance, would likely prove to be inconsistent with the long-term economic well-being of the nation.

Unemployment has been a very serious problem recently in the United States, as in many other countries. But this condition is mainly a product of the recession, which in turn was caused by the excesses and imbalances that had developed earlier in the economy. With economic recovery, good progress is being made in restoring jobs, and the unemployment rate has dropped 1-1/2 percentage points over the past year.

Substantial further progress is necessary in creating new job opportunities, thereby reducing unemployment and providing for the absorption of a steadily growing labor force. This must be a primary objective of governmental economic policy. It is also of crucial importance, however, that we avoid recreating the conditions that led to the past recession, and could do so again. This means that continued attention must be directed to questions of economic structure and balance, including avoidance of the extremely injurious effects of rapid inflation.

We at the Board are gravely concerned that the net effect of S. 50 would be to add substantially to the inflationary bias already evident in the performance of the nation's economy, without generating a lasting increase in productive employment opportunities. The events of recent years have demonstrated again that rapid inflation can undermine prosperity and exacerbate unemployment. The inflation of 1973 and 1974, with its adverse effects on real incomes, attitudes and the quality of economic decision-making, was a major force contributing to the subsequent deep economic recession. It should be clear from this experience that such conditions exact their toll in terms of economic inequity and social discontent. The American people have become painfully aware of the costs of inflation and of the need to control it.

It is of critical importance, we believe, that the containment of inflation be recognized explicitly as a national objective inseparable from the goals of maximum employment and production. Indeed, a principal flaw in the 1946 Act is its failure to identify clearly price stability as a long-run economic goal. S. 50 shares and extends this shortcoming. In the Board's judgment, the anti-inflation provisions of the bill are too weak and too vague to be satisfactory. Nowhere are there workable safeguards against inflation. Instead, the bill has many provisions that would contribute further to conditions and practices that would likely result in an intensification of upward price pressures.

Certainly one inflationary feature is the bill's objective of 3 per cent adult unemployment to be reached, and sustained, within four years following enactment. This is a most arbitrary target. Historically, a 3 per cent adult unemployment rate is very low. Over the past 30 years, the jobless rate for those 18 and over has been in the neighborhood of 3 per cent only during 1952-53 and 1968-69, years in which the number of men in the armed forces was over 3-1/2 million--half again as high as the present level. Moreover, both of these periods of heightened economic activity were characterized by demand-pull inflationary pressures and were followed eventually by major recessions. Thus, our postwar experience has been that achievement of 3 per cent unemployment is likely to be accompanied by substantial upward price pressures and followed by economic decline, rather than by sustained full employment.

In addition, the setting of a rigid unemployment goal ignores the dynamic character of the American labor force. The jobless rate of a decade or so ago does not have the same meaning as the current rate, principally because of the shifting composition of the labor force and the more liberal nature of our Federal income-support programs. Today's labor force has relatively more new entrants and reentrants--chiefly the young, and married women--than it did then. These groups typically have higher rates of joblessness as they search--often intermittently and through trial and error--for a satisfactory job. It is reasonable to think that this has biased the official jobless rate in an upward direction.

Indeed, the fact that the bill sets forth an unemployment target while making no mention of a comparable specific objective with regard to inflation is illustrative of its uneven treatment of these two economic problems. I would not urge that any fixed target for short-run price behavior be set; the meaning of an inflation rate, in its own way, can be as changeable as the meaning of a jobless rate. My purpose simply is to point out the bias of S. 50 in favor of one important national goal at the expense of another.

Some of the countercyclical and structural programs of S. 50 are likely to introduce important new elements of inflationary bias into our economic system. A significant problem of many past stabilization programs has been timing. Although the bill calls for the establishment of triggers and allocation formulas, I believe it still unlikely that we would avoid the pitfall of applying the aid too late in an economic downturn and continuing it too far into a recovery, when the effect on price pressures can be most pronounced. Experience has shown that such defects in timing have been particularly marked in programs of accelerated public works--one of the bill's recommended options. The inflationary implications of some of the other suggested programs--including those to stabilize State and local government budgets over the cycle and to extend unemployment insurance--also require careful evaluation.

The major inflationary thrust from the countercyclical programs, however, would come from the specific provisions of this bill that make the Federal government the employer of last resort. While worthy in principle, the program as specified in S. 50 has a critical flaw. It requires the payment of prevailing wages, defined where applicable as the highest of the following: the Federal minimum wage, the State or local minimum wage, the prevailing wage in State or local government, or the prevailing wage in construction as specified by the Davis-Bacon Act.

This program--and these wages--would have profound inflationary consequences for several reasons. First, the program would result in substantial cost-push pressures. Private labor markets would be tightened, and this would cause private employers to bid up wage rates in order to obtain and retain workers. Also, by making public jobs available at attractive wages as a matter of right, the program would encourage workers now employed in the private sector to press for even larger wage gains, or to transfer to governmental jobs. As an example, any construction project under this bill would pay the going union rate; but since a large proportion of building in the U.S. is nonunion, this wage would be higher than many construction workers now receive and would provide an alternative preferable to their existing jobs.

Second, the employer of last resort program, as specified, would very likely come to generate significant demand-pull pressures on prices. Given our national reluctance to raise taxes sufficiently to cover increases in government spending, the financing of the program would tend to add to the Federal deficit--very substantially so, at some points in time. In this fiscal year, for example, the Federal government is spending close to $3 billion to support some 320,000 public service employment jobs in State and local government. The program proposed by S. 50 has the potential of being many times larger than this. Its attractive wage provisions would draw not only from the unemployed but also from those working part-time or at less desirable jobs, and from those not presently in the labor force, including retired persons, housewives and students. The upper bound of potential participation cannot be estimated with any degree of accuracy. But it seems quite possible that several million jobs might come to be needed to employ all of those seeking these positions at the relatively attractive rates of pay that would be offered. Such a program might therefore involve $30 billion or more in outlays at current average pay scales. I might note also that we have learned from the existing public service employment programs that cost offsets in terms of reduced transfer payments under other programs may not be as large as is often thought. Only about one-fourth of public service program enrollees in 1975 had been receiving unemployment insurance or public assistance prior to participation in the program.

Far and away the most significant defect of the bill as far as inflation is concerned, however, results from the limitations it places on the exercise of monetary and fiscal policy. If I interpret S. 50 correctly, such policies are to be directed solely to the achievement of the 3 per cent unemployment goal until this target is reached.

Only when that rate is below 3 per cent can macro-economic tools be directed in any degree to the problems of inflation and economic instability. Instead, these fundamental techniques of demand management--used throughout the world in governmental efforts to combat inflation as well as unemployment--are to be supplanted in the bill by a series of specific program initiatives. The list of these substitute measures includes the following: a comprehensive information system to monitor inflationary trends; programs to encourage greater supplies of goods, services and factors of production; export licensing; establishment of stockpile reserves of food and critical materials; encouragement to labor and management to raise productivity through voluntary action; and proposals to increase competition.

Whatever the individual merits of these programs--and some are worthy of careful consideration--one fact is abundantly clear. They do not constitute an effective policy of inflation control. We believe that it would be a most serious mistake to discard the use of monetary and fiscal policy for stabilization purposes without first finding some effective alternative means of constraining inflation on an enduring basis.

Moreover, the bill's adoption of a trigger point with regard to economic goals simply does not provide a workable basis for employing accumulated knowledge about the behavior of the economy. It would not be practicable, in my view, to focus macro-economic policies exclusively toward a full employment goal and then, at a given point, abruptly shift attention to the containment of inflation. That is analogous to approaching a stoplight at top speed, and then applying the brakes with equal vigor;

the momentum would be sure to carry one into the intersection, or the deceleration to send one through the car's windshield, or more probably both. There needs to be the latitude to modulate and balance policy objectives to changing economic circumstances if we are to have any hope of achieving a lasting economic prosperity.

The changes required by the bill would go considerably beyond narrowing the options for modulating macro-policy objectives in accord with perceived needs of the economy. They would also alter dramatically the features of the existing process for review and oversight of the monetary policy function. In this regard, I would like to direct my comments to two specific provisions. First, the President is required to recommend a particular plan for monetary policy and to submit it annually to the Congress along with his numerical goals for employment, production and purchasing power. Second, within 15 days of the President's report, the Federal Reserve Board is required to submit its intended policies for the coming year to the Congress, indicating the extent to which its plans support the goals of S. 50 and providing justification for any variation from the President's recommendations.

The Federal Reserve Board strongly objects to these proposed new procedures on two grounds: (1) they would alter the traditional relationship between the Congress, the Federal Reserve and the Executive Branch in a way that could well prove detrimental to the economic well-being of the nation, and (2) the procedures specified would seriously impair the current operational flexibility needed in the formulation and conduct of monetary policy.

The Federal Reserve Act was carefully drawn to specify a relationship between the Congress and the Federal Reserve System that would serve to insulate the monetary authority from short-run political pressures. This feature of the Act stemmed from a well founded concern that excessive government spending could be aided and abetted if the executive were granted the authority to control a nation's money supply. It is a fact of economic history that governments everywhere have come under great pressure to engage in massive deficit spending, at one time or another, even though this patently jeopardized the longer-run health of the economy. History also is replete with the inflationary consequences that have followed when governments have given in to such temptations, and have then simply run the printing presses in order to supply the money needed to finance their deficits.

The need to turn to private financial markets in order to finance deficit public spending performs an important function. The process of financing shifts purchasing power from private savers to the government, thus neutralizing much of the potential inflationary effect of deficit financing, while the necessity of finding willing investors imposes a market discipline on the scale of such deficits. But even in the United States, where this discipline has largely prevailed, the Federal budget has been in deficit every year but one since 1960. There is nothing in this record that suggests that we can relent in the battle to avoid excessive deficit financing. But instead S. 50 proposes to weaken one key safeguard against inflationary public finance by introducing the Executive Branch explicitly and publicly into the making of monetary policy. And were the Congress to mandate these new procedures, it also would significantly dilute its preeminent role in the oversight of the monetary policy process.

Moreover, the proposed procedures for the planning and evaluation of monetary policy are, for operational reasons, inferior to those now in place. Under House Concurrent Resolution 133, the Federal Reserve Board reports on economic and financial developments, and specifies its current expectations for a variety of monetary aggregates on a quarterly schedule, alternately before the Banking Committees of the House and Senate. The great advantage of this reporting procedure is that it permits the Federal Reserve the flexibility necessary to adapt monetary policy to changing economic conditions. The procedures proposed in S. 50 would curtail such flexibility.

There are two major changes in the existing process required by S. 50: (1) policy planning is moved from a quarterly to what would effectively be a 12 to 15-month reference period, and (2) there would appear to be a fixed commitment to longer-term plans for monetary policy in support of specified numerical national economic goals. On the basis of experience, the Board is convinced that these changes would make the proposed planning and evaluation process too rigid to be workable. As this Committee is aware, the ability of economists to forecast economic events for a year or more into the future with any high degree of reliability simply does not exist. Two rather notable recent illustrations of forecasting imprecision come quickly to mind: the extraordinarily high rates of inflation that developed in 1973 and 1974 that virtually no one foresaw, and the severity of the 1974-75 recession, which was also quite unexpected. In either case, it would have been a serious error to adhere to outdated plans based upon economic forecasts that proved to be wide of the mark.

In addition, the current state of knowledge about the relationship between movements in the monetary aggregates and real economic activity is not nearly so precise as the comments of some economists would have you believe. In recent quarters, for example, there appears to have been a dramatic reduction in the amount of money needed to accommodate the expansion in GNP. Under these cirucumstances, holding to a course of monetary growth that might have been suggested by historical money/GNP relationships could have been quite damaging. Speculative activities would have been encouraged, thus sowing the seeds for future economic instability, and the foundation might well have been laid for a renewal of intensified inflationary pressures.

Technical and financial innovations, accompanied by regulatory changes, undoubtedly have accounted in part for the slower growth in the narrowly-defined money stock. For example, the spread of overdraft checking account credit privileges, increased use of credit cards to facilitate transactions, and the introduction of savings accounts at commercial banks for business firms all have tended to encourage greater economizing in the use of currency and checking account balances. These effects could not have been estimated with any accuracy in advance, however, and in any event, I do not think that they provide a complete explanation. The fact is that there is a potential for short-run volatility in monetary relationships that can make economic forecasts based on monetary inputs quite treacherous.

These uncertainties about monetary and economic relationships require exceptional vigilance and flexibility by the Federal Reserve, and serve to point out the need for flexibility as an attribute of the monetary policy process. Ours is a complex and dynamic economy; its linkages and responses are still imperfectly understood and probably always will be. Thus, in order to accomplish the objectives of economic stabilization, the formulation and conduct of monetary policy need to retain their flexibility to adapt to unforeseen developments in our economic and financial system. For these reasons we believe the provisions of S. 50 with respect to the monetary policy planning process would serve to impair the contribution the Federal Reserve can make in helping to achieve our national economic goals.

Let me turn now to what this bill has to offer by way of improving the trade-off between unemployment and inflation.

We have all painfully learned that the unemployment-inflation trade-off--which is generally thought to be shaped by our human and material resources, our economic institutions and processes, and our social practices and aspirations--has grown distinctly more unfavorable in recent years. A simple but useful illustration of this deterioration is the so-called discomfort index, which adds together the unemployment rate and the rate of increase in consumer prices. Last year, that index was 15.6, while a decade ago it was 6.4 and two decades ago 4.8.

High unemployment side by side with high rates of inflation presents the most difficult problem facing economic policymakers, not only in the United States but throughout the world. The sources of this problem are far from fully understood, but an important part appears to be structural in nature and, therefore, relatively immune to monetary and fiscal policy. A look at the composition of unemployment figures illustrates some of the structural impediments in labor markets. Groups experiencing the greatest barriers--discrimination, marginal skills, location in depressed areas--have jobless rates well above the national average, even when the economy is not in a recession. For example, in the pre-recession year of 1973, when the national average unemployment rate was 4.9 per cent, black joblessness was 8.9 per cent, while 14.5 per cent of all teenagers in the labor force were unemployed.

The bill properly recognizes the importance of structural problems and suggests a variety of programs to alleviate them. There are many such programs that might prove beneficial, but I believe that two broad areas deserve special emphasis. First are programs that would help increase competition in product and factor markets. There is need to reassess the effectiveness of our antitrust legislation--with regard to both business and labor practices--and the anti-competitive effects of Federal regulation of all kinds. We need also to reexamine the costs and benefits of such Federally mandated programs as the Davis-Bacon Act, the minimum wage for teenagers and extended unemployment insurance. Second are programs that would serve to increase over time the employability of the jobless. We need better and more imaginative training programs and an improved labor market information system that would match job vacancies with available people, perhaps on a national basis.

Other programs are worthy of consideration. We should find effective ways to encourage more investment in productive plant and equipment, through stronger incentives and perhaps some revisions in the tax laws. We should stress programs to improve efficiency in both the private and public sectors. In this regard, the Board would endorse the principle of zero-base budgeting, which appears to be contemplated by the feature of S. 50 requiring the review of one-fifth (by dollar value) of all Federal government programs annually.

A new emphasis on structural programs such as these, together with prudent monetary and fiscal policies, will provide our best hope for achieving the goals of the Employment Act of 1946. But the Board believes that S. 50, while reasserting these goals, would in the end be counterproductive in the effort to achieve them. The bill would release a powerful combination of demand-pull and cost-push pressures on prices. As has been demonstrated by the experience of many other countries--and, to a degree, by our own experience of recent years--rapid inflation can breed economic instability and ultimately retard--not promote--the growth of productive jobs. If we are truly to commit ourselves to the broad goals of the 1946 Act, we need programs and policies that achieve a greater balance among our economic objectives than is recognized in S. 50.

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