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Statement by

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before the

Subcommittee on Domestic Monetary Policy

Committee on Banking, Finance and Urban Affairs

House of Representatives

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I am pleased to appear before you today, on behalf of the Board of Governors of the Federal Reserve System, to discuss the important questions that you have raised regarding the impact of federal deficits on the supply, distribution and price of credit, on inflation, and on the conduct of monetary policy.

I would like to begin with the question of the relationship of budget deficits to monetary policy. There is a common and serious misconception that federal deficits must be financed by creating money. In fact, in the large and sophisticated capital markets of the United States today, sizable federal deficits can be financed without intervention or assistance by the Federal Reserve. The Treasury sells securities in the open market at the interest rate necessary to attract a sufficient volume of bids. Whether the Federal Reserve System absorbs into its portfolio any of the resultant increase in Treasury debt depends entirely on the amount of reserves that is needed to support the growth rates of money that the Federal Reserve has targeted.

Monetary policy has not always been so independent from debt management policy. In the period of large deficits during World War II, the Federal Reserve bought the amount of Treasury securities necessary to peg interest rates at low levels.

The result was a lack of control over growth of money and credit, and an excessive build-up of liquidity, that contributed to the inflation of the immediate postwar years. In 1951, the "Accord" between the Treasury and the Federal Reserve freed the System to conduct an independent monetary policy. For a while thereafter, the Federal Reserve did avoid actions that might substantially alter market conditions in the midst of a Treasury financing operation--the policy known as "even-keeling." But even this practice was ended some years ago when the Treasury adopted the more flexible technique of selling securities by auction. Thus, there is no necessary or mechanical link between federal deficits and the conduct of monetary policy.

This certainly does not mean, however, that sizable federal deficits do not affect financial markets, or that they are insignificant in the struggle to reduce inflation. On the contrary, when the Federal Reserve is restraining the growth of money and credit to slow inflation, as we are now doing, the credit demands of the federal government have enormous significance for interest rates and the ability of private borrowers to obtain funds. The federal government, in effect, takes its place at the head of the credit line, and since aggregate credit supplies are being constrained, private borrowers are squeezed out.

Whether private credit use is cut back by rising interest rates or by nonprice rationing of credit depends on the institutional environment. In the past, financial markets were characterized by a good many barriers to flows of funds, most importantly low ceilings on rates payable on time and savings deposits, and legal barriers on the interest rates that lenders could charge or that borrowers could pay. In those circumstances, a rise in market interest rates led to disintermediation at depository institutions and a decline in the availability of credit to potential homebuyers, farmers, small businesses, and others. Usury ceilings also served to reduce mortgage credit availability, and laws and constitutions of many states periodically prohibited states and their political subdivisions from paying going rates of interest in the money and capital markets.

Today, with most of those barriers gone, the nonprice rationing mechanism has been largely dismantled. Borrowers generally are able to obtain credit if they are able and willing to pay the going rate. This means, however, that interest rates must rise to higher levels than they used to in order to reconcile overall credit demands with available credit supplies.

Those interest levels will be very high if inflationary pressures are strong and expectations are widespread that inflation will continue. Lenders will then demand an inflation premium, and borrowers will be more willing to pay it. In view of the rapid rates of inflation that we have experienced in the recent past, the inflation premium in interest rates is large. A lasting reduction in interest rates will only occur as we bring inflation down. That is why monetary policy must remain steadfastly on an anti-inflationary course.

The burden of high interest rates is very uneven on the various sectors of our economy. The housing industry has been devastated; many auto dealers have closed their doors because of declining sales and extremely high costs of financing inventories; small businesses in other lines are also going out of business. The thrift industry is experiencing a severe squeeze on earnings; high interest rates will also impede the rise in business capital formation that we need for improvement in productivity performance, thus offsetting some of the beneficial effects of the business tax cuts included in the Economic Recovery Act of 1981. Meanwhile, some industries--such as defense, energy production, and high technology--appear to be thriving despite extraordinarily high interest rates.

Heavy federal demands in credit markets, to be sure, do not always imply high interest rates or appreciable crowding out of private borrowers. For example, if the deficit to be financed were solely the consequence of a decline in revenues that occurred because of a recession, the weakening of private credit demands would more than offset the rise of Federal borrowing. The important problem we face today, however, is a persistent long-run growth in the proportion of funds raised in the money and capital markets by the federal sector.

The table attached to my testimony shows that the federal share of overall borrowing has been on an uptrend over the past 25 years. The first column shows the sharp rise in the proportion of total credit flows that is pre-empted by direct Treasury borrowing. A pause in the upward trend occurred in the latter part of the 1960's when the economy experienced a prolonged cyclical expansion. The strength of incomes and the belated Vietnam tax surcharge elevated tax receipts and reduced the federal deficit. Subsequently, however, the share rose again, and in the latter half of the 1970's was running at close to 20 percent.

If borrowing by government sponsored agencies--such as the Federal Home Loan Banks and the Federal National Mortgage Association--is included in the totals, the share of total credit flows absorbed by the Federal sector is somewhat higher. The

precise significance of this calculation, however, is hard to judge. Some of the borrowing of sponsored agencies merely makes available to borrowers credit that they would have obtained through private channels anyway; in those cases, the total demands on credit markets are not increased.

Another important aspect of federal intervention in credit markets is private borrowing under federal loan guarantees. In the 1940's and 1950's, federal loan guarantees were significant in the mortgage market as a result of the strong demand for housing and the high risks that lenders attached to nonguaranteed mortgages following the disastrous experience of the great depression. As these factors became less important, federal mortgage guarantee activities shrank relative to the size of the mortgage and total credit markets but, by the 1970's, new types of guarantee programs began to swell the total once again.

The significance of federal loan guarantees for assessing the strains on credit markets emanating from the federal sector is also unclear. All we can say with certainty is that the amount of direct Treasury borrowing understates to an unknown degree the total demands of the federal sector on credit markets. We also know that a sizable proportion of total credit flows are being influenced one way or another by the activities of federal credit

programs. Indeed, by the latter half of the 1970's, fully a quarter of the funds raised by the financial and nonfinancial sectors of the economy represented either direct Treasury borrowing or federal intervention and redirection of credit flows through the activities of sponsored agencies and guarantee programs. In fiscal 1981, the figure was well above 30 percent.

It is essential that federal deficits be controlled if strains in financial markets are to be reduced and if the private sectors of the economy are to increase their share of real resources without the often inefficient intervention of special federal credit assistance. What are the prospects for the federal deficit? Estimates for the deficit in fiscal year 1982 vary widely, but it really is the outlook for subsequent years that is most troubling. For example, the estimates of the Congressional Budget Office suggest that, even if all of the spending reductions anticipated by the First Concurrent Budget Resolution were implemented, the Federal deficit would be \$50 billion or larger in each of the years through 1984. This projection, moreover, assumes \$50 billion in additional spending reductions by fiscal 1984 that have not yet been enacted, and a fairly optimistic outcome for real economic growth. In the absence of the additional \$50 billion in expenditure reductions assumed, the deficit in fiscal 1984 could be \$100 billion or even larger.

Continuation of deficits of this magnitude would imply persistent pressures on interest rates. Uncertainties regarding the ability of the Administration and the Congress to take the actions necessary to change these prospects are evident in the bond markets, where long-term interest rates have remained near peak levels even while short-term rates have receded markedly over the past couple of months.

In this setting, the alternatives are clear. One is to move ahead with further reductions in federal spending. To achieve a balanced budget by 1984, we will probably need reductions in outlays in fiscal 1984 of somewhere around \$100 billion. If cuts of that magnitude are not feasible, or are deemed by the Congress to be unwise, the only alternative is to restore some of the cuts in revenues contained in the Economic Recovery Act of 1981.

Let me conclude my remarks by noting that we are seeing signs of progress in the fight against inflation. Both consumer and producer prices have risen less rapidly this year than last; indeed, we have seen more progress in reducing inflation in 1981 than almost anyone had expected. The first signs of progress are also beginning to appear on the wage front as well. Contract re-openings and wage concessions have occurred in a number of industries and the environment for the new round of union contract negotiations that will begin next year should favor much less

inflationary settlements than have characterized the recent past. Significant progress in conservation of energy has narrowed the latitude of OPEC to impose major increases in oil prices. And, in 1982, the upward pressure on wages and costs from increases in the minimum wage and social security taxes will be less than in the current year.

We have reached a critical stage in our fight against inflation. We can consolidate our gains and move forward to price stability. If we do not, we will almost surely see a return to double-digit inflation.

The Federal Reserve is determined to stay with a course of monetary policy that will reduce inflation. Eventually, the course of monetary policy on which we are embarked will, in fact, reduce inflation and bring down interest rates in the process. Our country will achieve the goals of reasonably stable prices, lower interest rates, and a more vigorous and prosperous economy much sooner, however, if the Congress and the Administration work together to eliminate the prospects for very large federal deficits in the years ahead.

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MEASURES OF FEDERAL PARTICIPATION IN
CREDIT MARKETS, FY1956-FY1980
(5-year averages, percent)

Fiscal Years	Treasury Borrowing as Percent of Funds Raised by Nonfinancial Sectors (1)	Treasury plus Sponsored Agency Borrowing as a Percent of Total Funds Raised <u>1/</u> (2)	Treasury plus Sponsored Agency Borrowing plus Borrowing for Loan Guarantees as a Percent of Total Funds Raised <u>1/</u> (3)
1956-1960	3.9	6.1	16.4
1961-1965	8.4	9.1	16.9
1966-1970	5.3	8.7	14.9
1971-1975	13.3	15.8	22.7
1976-1980	18.8	20.0	25.3

1/ Total funds raised includes borrowing by financial and nonfinancial sectors.

Sources: Data on Treasury borrowing, Sponsored Agency borrowing, funds raised in credit markets by nonfinancial sectors and total funds raised in credit markets are derived from Flow of Funds Accounts, Board of Governors of the Federal Reserve System. Data on borrowing for primary guaranteed loans are derived from Budget of the United States Government, Special Analyses on Federal Credit Programs.