Notes for
Informal Speakers' Series
Graduate School of Management
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When Professor Harder invited me to talk with you, he suggested that I make a few opening remarks and then leave the rest of the time open for discussion. Given the wide range of interests you have, I think this is a good idea. Hopefully, the open discussion will give me an opportunity to zero in on some specific questions even though the answers may not be as simple as you like. It will also be more fun for both you and me.

Let me try to build a bridge across your interests in monetary and fiscal policies, government organization, and budget making by taking on two topics at the outset. First, I'd like to talk about planning, organizing, and controlling fiscal operations at the Federal Government level--in particular, the Budget Reform Act. Then, I'd like to move to the projected Federal deficits and what they mean for the Fed.

At the beginning of our nation's bicentennial celebrations, it is perhaps particularly fitting that this year and next we are seeing the beginnings of a new fiscal management experiment. Congress is now, for the first time, attempting to carry out its responsibilities for appropriating and expending the resources of the Federal Government in accordance with a preestablished plan.

The problems of planning, organizing, and controlling the fiscal operations of the U. S. Government are unlike those of any private business organization. In any successful private business organization, the executive arm establishes the budget, authorizes expenditures, and controls the fiscal process in all its ramifications, with careful internal controls plus an outside audit. Not Uncle Sam, however. Under our constitutional form of government, our system of checks and balances, is far more intricate and far more cumbersome. While the executive arm may propose an expenditure plan and is responsible for most of the actual spending, control of both the raising of revenue and the appropriation of resources is lodged in the Congress.

It is indeed ironic that the American Revolution occurred largely because of the insistence on the part of the colonists that they were entitled, via their elected representatives, to have control over the government's purse. Yet, in the 200 years that followed, the initiative on the Federal budget has resided primarily largely in the hands of the executive. Congress, to be sure, regularly has to authorize programs, pass the appropriation bills to fund those programs, and approve the details of the taxing and borrowing procedures to raise the necessary funds. But it was the Administration alone which had the mechanism available to look at the total picture and to establish resource priorities. And it is only in recent years that the Administration had the time or expended the effort to look much more than a year down the road as program after program was initiated which, while starting small, had large--frequently progressively growing--costs built in for future years. We are now at a point where about three-quarters of our annual Federal expenditures are now classed as "uncontrollable" as far as the executive branch is concerned. These are expenditures necessary to pay for programs set in motion in earlier years, and which can be modified politically only slowly over the next several years, if, indeed, they can be modified at all. The Congress fragmented its budget making efforts by assigning consideration of appropriations to 13 loosely co-ordinated sub-committees, and then ducked the appropriation process completely with billions of dollars of backdoor spending, and it faced up to the overall picture of receipts, expenditures, and deficit only after the fiscal outlook forced the Treasury to ask for an increase in the public debt limit--a silly political exercise at best.

But now we are in the first phases of a new experiment aimed at supplying the Congress with the tools to look themselves at the priorities submitted to it by the Administration in a coherent and comprehensive way. This requires Congress to make an independent judgment on priorities for spending, and to present a Congressional overview of appropriate fiscal policy considering the needs of the economy each year. This is to be accomplished through Budget Committees in each house which will establish appropriate levels of total spending in relation to likely receipts from taxation, and to consider the implications of the resulting deficit, and lay down general priorities for apportioning total spending among the demands of the individual categories of spending. A Congressional Office of the Budget now provides detailed input on the impact and structure of the budget to the budget committees and to individual legislators.

While the effort for the coming fiscal year is just a dry run in anticipation of fiscal 1977, when the Congressional budget process becomes mandatory, a number of promising major steps have already been taken. First, excellent professional staffs have been acquired to provide the human resources. Second, both committees have provided their respective houses with proposed budget resolutions for action during the current session.

We are now at the stage where we must see how effectively the two houses of the Congress deal with the resolutions before them. They must arrive at and pass a compromise between the two versions and then apply the result to the detailed appropriation process. The success of the procedure next year, when the law makes it mandatory, will depend in large measure on how the test application works out this year. The new process must clearly impinge on the long-sacred prerogatives of both the substantive committees responsible for program authorization and the appropriations committees if it is to be successful. This will require compromise and adaptability, which is going to be politically difficult to achieve. In the process, it is quite possible that some of the details of the present law may have to be altered to achieve a smoothly running mechanism. Nevertheless, I am confident that the program will be successful and that the end result will be that Congress can fulfill its Constitutional responsibility in the ordering of the nation's priorities in a much more effective fashion than has ever been done in the past. In fact, we may see the Federal Government handling finances in the way I think the founding fathers intended--a mutual interchange between Congress and the Administration for the first time in 200 years.

But aside from the new system, we still have to wrestle with the deficit of $60 to $80 billion already projected for this coming fiscal year. Everyone here is aware of the discussions concerning the implications of the large projected deficits for Federal Reserve policy, but in the interest of completing the bridge, I'd like to talk with you about this from my vantage point--particularly with the rest of calendar year 1975 in mind.

First, I think we should have some idea of what total credit demands are likely to be over the near-term. Most flow-of-funds studies made early this year show a sharp decline in non-Federal borrowing. For example, an analysis made by one of the principal New York banks indicates that the net demand for funds in the economy excluding Treasury and Federal agency borrowing will fall by about $30 billion in 1975. However, the net demand for funds by the U. S. Government, including both the budget and sponsored agencies, is projected to increase about $52 billion over last year's demand. Thus, the increase in Federal borrowing is expected to more than compensate for the decline in other sectors. Assuming a nominal GNP of $1,500 billion for 1975, the net demand for funds projected of $237 billion would be about 16 percent of nominal GNP. This compares with an estimated 18 percent, 17 percent, and 15 percent of nominal GNP in the years 1972, 1973, and 1974, respectively. In this context, then, there is nothing particularly extraordinary about total credit demands in 1975, only their composition.

Looking a little deeper into the composition of estimated private borrowing for 1975, the figures I've cited show a sharp decline ($28 billion) in short-term business borrowing and a modest increase ($7 billion) in long-term business borrowing (including corporate equities and mortgages). One of the principal reasons for the decline in short-term borrowing is the inventory liquidation that is going on. The increase in long-term borrowing is mainly an attempt by corporations to fund their short-term debt, thereby improving their liquidity positions.

If, as many forecasters believe, a vigorous recovery in economic activity does not occur in the second half of 1975, the above analysis indicates that the Treasury should be able to place its debt without any major difficulties, especially its short-term issues. With the large decline in short-term business borrowing, the banks are expected to be aggressive buyers of bills and intermediate-maturity coupons. Banks, like other corporations, also need to shore up their liquidity positions. Some problems may arise when the Treasury moves into the longer-term area, and thus begins to compete with corporations for funds. We have already seen evidence of this as a number of corporate issues were cancelled in recent weeks. When we call this a problem though, we should specify <u>whose</u> problem it is. As long as the Treasury is willing to pay the market price, it is clearly going to be the private borrowers' problem.

We can, however, see real pressures in the money and capital markets in 1976 and 1977. During that period, the economic recovery certainly should be well under way. Business short-term borrowing will accelerate in order to finance higher inventories. Increased plant and equipment expenditures will probably lead to increased long-term borrowing. On top of this, federal borrowing will remain strong, at least through the first half of 1976.

Faced with increased loan demand, the banks are likely then to reduce their holdings of Treasury securities in order to accommodate this loan demand. This will put additional pressure on interest rates and lead to an increase in money velocity, thus, making the Fed's job of sustaining a recovery and, at the same time, preventing a new round of inflation, even more complicated.

What is the Fed's responsibility to the Treasury in the face of these relatively high deficits? Certainly, we have some responsibility for viable markets. But beyond this, I believe that the Federal Reserve's responsibility is to increase the money supply (preferably M_1 or M_2) at rates which would allow real output to grow at its long-term trend rate of growth without producing a rate of inflation above that acceptable to society. If corporations suddenly decided to increase sharply their borrowings to such high levels that would not be consistent with real potential output and society's desired rate of inflation, would the Fed have any responsibility to them to keep interest rates down to levels that would allow this planned borrowing to be realized? I think not, even though the risk of Congressionally designed interest rate controls can be great under such circumstances.

A number of analysts have said that the Fed could monetize a large portion of the new Treasury debt in 1975 and thereby hold down interest rates without any fear of rekindling the fires of inflation because of the tremendous amount of excess capacity in the economy. Indeed, many of the models show a good trade-off between unemployment and inflation through the end of 1976 with relatively rapid rates of growth in M_1 for the remainder of 1975 and a dampening in M_1 growth thereafter. I have two problems with this analysis. First, although there undoubtedly is a lot of excess capacity in the economy today, it may be as great as some would have us believe. The increase in the price of oil, new pollution control laws, and new work-safety legislation have rendered some of our productive capacity obsolete. Just how much is difficult to tell. But if we try to increase economic activity too much over a short period of time, we may run into capacity constraints faster than anticipated. Labor Secretary John Dunlop warned of this, particularly in the areas of electrical generating capacity, refining capacity, and the production of primary goods, in the Wall Street Journal on April 17. Another reason for being reluctant about accepting too rapid a growth in M_1, that is, the monetization of a large part of the new Treasury debt, over the remainder of 1975 is the likely difficulty of restraining money supply growth in 1976. I suspect that to do this, we would have to let the Federal funds rate rise by a fairly large amount in a short period of time. This would be reflected in other rates and Congress would quickly switch from being monetary aggregate critics to rate critics. Congressmen are fundamentally rate watchers anyway. They shift to criticism on inadequacy of money supply only when it serves their rate arguments.

The Treasury is offering a lot of short-term maturities, such as bills and two-year notes, in its financing of the deficit. This means that its refinancing needs will be heavy over the next few years. In years past, frequent Treasury financings could have interrupted or prevented the implementation of Federal Reserve countercyclical monetary policy because of the way in which Treasury coupon issues were marketed. The Treasury used to set the price and coupon, and thus, the effective yield, on all its offerings except for bills. As a result, the Federal Reserve assumed some responsibility for keeping the Government securities market stable during Treasury coupon offerings so that the new issues would remain competitive with seasoned issues, at least until the subscription books were closed. Now, however, almost all Treasury marketable issues are auctioned, and it is virtually impossible for an issue to fail because of a sudden change in the market. Rather, the Treasury simply pays a higher or lower rate of interest, depending on which way the market moves.

In summary then, I do not think the Fed will encounter significant difficulties this year from the financing of the Federal deficit. We will have some leeway, but we must still concentrate on keeping the money supply growing at rates that would promote a sustainable rate of growth in real output with a minimum amount of inflation. This is not to say that we should not and will not aid the Treasury if temporary market congestion develops in certain maturity areas. For example, if our money supply projections indicate a need for $100 million of reserves and at the same time, the long-term market is experiencing difficulty, then I would have no quarrel with concentrating our purchases in this sector. Finally, it should be emphasized again that the Fed's actions are now less constrained by the Treasury's marketing of Government debt under the auction technique. Ten years ago, the implications of these deficits for the Federal Reserve would have been vastly more complicated.