

THE MERCHANTS BANK

BOARD OF DIRECTORS
MEETING

Kansas City Club

June 26, 1984

I am very pleased that you invited ^{and your directors} me to share this ~~important~~ occasion with you ~~tonight~~. Your ~~honoree~~, ~~Ray L. Hunt~~, is ~~widely recognized and respected for his perceptive and energetic business leadership~~. We in the Federal Reserve always appreciate opportunities to meet in gatherings like these to consider issues that concern both the Federal Reserve and business people everywhere. In particular, I know that we share a mutual interest and concern about the health of our national economy. Therefore, I would like to visit with you ~~tonight~~ about the current economic situation and about the role that monetary and fiscal policies play within that outlook.

In discussing these issues, I am acutely aware that central bankers often are prone to take ^{rather} a somber view of the world. In this connection, I am reminded of a remark I heard recently that central bankers are very much like ^{the early} Puritans. They have a haunting fear that someone, someplace, may be happy! Naturally, as a central banker, I don't want to fall out of character and leave you too happy. However, I do promise to be as objective as possible, looking at both the significant progress we've made recently in terms of economic performance as well as the problems and challenges we have yet to face and resolve.

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First, then, let's look at the current economic situation. As you all know, economic growth was surprisingly strong in 1983 and on into the first quarter of this year. Industrial production has shown continuing strength and idle capacity has

declined. Housing growth nationwide has exceeded expectations and automobile sales have rebounded vigorously from recession ^{any} lows. With the unemployment rate continuing to move downward and personal income rising, more consumers have had more dollars to spend. As a result, retail sales have continued to lead the economic expansion and businesses continue to place orders to rebuild their inventories. Reflecting this strength in the economy, businesses have stepped up their spending plans for new plant and equipment. Given this momentum, I believe the economy will remain strong throughout 1984, although some moderation in the pace of growth ^{should} ~~may~~ become evident later in the year.

A key factor in the economic outlook for 1984 is the role that monetary policy will play. As most of you know, monetary policy has earned considerable credibility in the financial markets and among the American public. ^{Generally} This credibility results from the Federal Reserve's consistent adherence to a firm anti-inflationary policy in recent years—a policy which is generally credited for much of the success to date in bringing inflation under control. Let me assure you that the Federal Reserve remains committed to providing money and credit to the economy at a pace which will provide for a sustainable business expansion while, at the same time, maintaining progress toward price stability.

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Given this favorable economic outlook, what then has happened lately to cause general concern on the part of many

people? Why, for example, have interest rates in the money and capital markets risen over the past month or two, and why have equity prices come down ^{at the same time?} ~~simultaneously?~~ Moreover, ~~why has the dollar weakened lately in foreign exchange markets after reaching record highs late last year~~ and why are some people talking about a possible downturn in business activity in 1985 or 1986?

The answer to these questions, in my judgment, is that there is a basic concern that our economy may be in the process of tracking the boom-bust business cycle so typical of the 1970's. During that period, as you recall, whenever there was a downturn in the ~~private~~ economy, expansionary policies were promptly adopted by economic policymakers. Unfortunately, those policies tended to be held in place much too long. As a result, inflation increased sharply and economic growth eventually was halted in its track.

Currently, as I've indicated, we are again in the expansionary phase of the business cycle. Indeed, some people today are concerned that the pace of the expansion is proceeding too rapidly. Unlike previous periods, though, Federal Reserve monetary policy is not contributing to an excessive growth in the economy. Rather, we are intentionally gearing policy to provide for a moderate and sustainable economic growth rate. At the same time, though, the government's fiscal policy is continuing to provide an expansionary thrust to the economy through enormously large budget deficits.

These budget deficits, which are large as far out into the future as one can reasonably see, lie at the root cause of the current malaise in ^{the} financial markets. The credit markets realize, I believe, that despite the current robust condition of the business expansion, large budget deficits threaten the very vitality of the American economy. Most certainly, the recent upward movement of interest rates, the weakness of stock prices ~~and the U.S. dollar~~, and the concern about a reemergence of inflation, all stem from the view that the government's budget deficits are incompatible with a healthy U.S. economy. Since these deficits are the most serious economic problem likely to affect our economic future, I want to discuss them more fully with you.

In thinking about the economic impacts of budget deficits, it is useful to remember that deficits in and of themselves are not necessarily bad or inappropriate. For example, when the economy is struggling to overcome recession, such as in 1981 and 1982, deficits can be useful to generate growth and employment by increasing the government's demand for goods and services. But when the economy recovers and begins to grow strongly, such as in 1983 and early this year, deficits are not needed to encourage growth and, in fact, lead to serious problems. These problems are manifested in terms of higher interest rates, a renewal of inflationary expectations, and a reduction in the economy's potential for further economic growth.

First, let's consider the impact of large deficits on interest rates. Because budget deficits must be financed by borrowing in credit markets, massive ongoing deficits increase the competition for ^{the} available ~~supplies~~^y of credit. Moreover, as economic expansion continues, rising private sector credit demands from businesses, farmers, and home buyers will collide with the government's borrowing needs. As this occurs, interest rates tend to be higher than they otherwise would be and the private sector is increasingly "crowded out" of the credit markets. In 1983, this type of "crowding out" occurred only to a minor extent because our domestic savings were supplemented by a heavy inflow of foreign capital.

A second concern related to the large federal budget deficits is the problem of rising inflationary expectations. As the economy continues to expand, and as growth in public and private credit demands put upward pressure on interest rates, public fears about renewed inflation become more widespread. These concerns may affect individual and business decisions about wages, saving, spending, and investment. Occurring in combination with rising interest rates, such renewed inflationary expectations seriously damage the foundation of sustainable noninflationary growth we have put in place at such a great cost in recent years.

I am concerned, as well, that some misguided ^{individuals} ~~voices~~ will call for the Federal Reserve to ease the deficit financing problem by ^{merely} creating more money. I believe that most thoughtful

people now realize that creating an excessive supply of money and credit is clearly not a viable solution to massive federal deficits. Such action would only add to ^{the} public concern about future inflation and rising interest rates. Moreover, considering how far the economy has come thus far in the fight against inflation, it would be ^{in my judgment} irresponsible for us to foresake these gains by monetizing the large deficits.

Although the near-term problems associated with the deficits are very troublesome, the continuing large budget deficits in the so-called "out years" also introduce major risks to the nation's economic future. These risks go *well* beyond questions of interest rates and inflationary expectations and are related directly to the role of private decisionmaking in our society.

Accelerating federal, state, and local government spending and transfer payments now equal nearly 40 percent of our nation's gross national product. This large and growing size of government raises serious questions about the future of the private sector. If government continues to absorb a disproportionate share of private savings to finance programs and deficits, /it is clear that we risk drying up much of the private investment so necessary ^{continued} for real economic growth. But, more importantly, /a reduced private sector surely means a declining role for market forces and, thus, weaker incentives for the initiative and

innovation so characteristic of the American people. In short, the large government deficits are not only incompatible with near-term economic stability, but they also are incompatible with the long-run health and vitality of our free enterprise system. Given this view, there is every reason for the American people to demand action now on the deficit issue.

The deficit-reducing plans now being discussed—including the so-called "down payment" schemes—are classic examples of too little and too late. Such plans stop far short of the necessary action. They do not provide timely help because their effects ~~would be extended too far~~ *are pushed too far out* into the future. But more importantly, the budget reductions they propose are far too small to have any ~~real~~ *meaningful* effect on the onrushing economic impacts of the deficits. In my judgment, we are not yet facing up to the magnitude of the problem before us.

Unfortunately, the window of opportunity for action on the deficit is closing *rather* rapidly. I say this for several reasons. The most obvious reason is that the economy is now growing much more rapidly than earlier expected. Quarter after quarter, we see the economy's surprising staying power, suggesting that the clash of public and private credit demands may even now be upon us.

Another reason for believing that the time frame to act against the deficit is shrinking rapidly is that foreigners may not be willing much longer to continue to invest in the U.S.

economy. They increasingly see the U.S. economy as one that is living beyond its means, as evidenced by persistent budget deficits and deficits in our international balance of payments. The problem here is that, if foreign capital flows dry up, interest rates in the United States will rise as the full brunt of our domestic credit demands falls on the limited supply of our domestic savings.

~~Already, in fact, the U.S. dollar has weakened somewhat in international markets—possibly reflecting foreigners' unwillingness to accumulate further dollar claims.~~ Foreign exchange markets recognize that, as the United States continues to incur large international trade deficits and as we, in turn, resort to heavy foreign borrowing to finance those deficits, this nation will rapidly become a net debtor nation. If this trend continues, it is natural that foreign lenders will increasingly question the attractiveness of U.S. markets. These lenders also will ^{also begin to} question the underlying strength of the U.S. dollar.

A further reason for believing that we need to act now against the budget deficits is the possible ^{no} emergence of inflationary expectations. Many observers expect that the rapid business expansion that we are now experiencing will naturally prompt price increases for goods and services as economic slack evaporates. ^{although} ~~Over the~~ consumer and producer price indexes ^{has remained at} ~~have~~ ^{reasonably low levels,} ~~suggesting such a possibility.~~ Should an increase in prices

lead to inflationary wage settlements later this year, the resulting upward cost biases would carry into 1985 and 1986 and threaten the relative wage stability which has contributed so much to recent productivity gains.

With so much at stake for the future health of the economy, I know many of you ~~have~~ shared my frustration over the paralysis which ~~perpetuates~~ ^{Characterizes} the deficit problem. The root problem, it seems to me, is that the deficit is not just an economic problem, but an economic problem requiring ^a political ~~action~~ ^{solution}. Moreover, the situation is compounded because this problem requires action in an election year. The combination of these circumstances has led to the prevailing ~~attitude~~ ^{view} that nothing meaningful can be done about the deficit now. I reject that view.

I reject it because the economic deficits are solely a matter of public policy. They are not something that we cannot control. Rather, they are controllable if we wish to change our public policy. As such, we do have the power at our disposal to act through the deliberations of the American people ^{and administration} ~~and~~ the Congress, and we can begin right now.

The political realities of finding workable deficit-reduction proposals suggest that the most likely avenue for progress is through some combination of spending cuts and tax increases. ^{Fortunately} ~~It is not~~ ^{within} the province of the Federal Reserve to decide where, when, or how to cut spending or raise revenues. Such matters appropriately rest with ^{our elected officials} ~~the~~ Congress. But it

seems to me that we soon must agree on ^{the} principles ^{that will} guide our action at this critical juncture.

One important objective of any plan to reduce the deficits, in my judgment, is to preclude any further growth in the role and size of government in our society. Accordingly, I believe any deficit reduction plan should give greater weight to curbing government spending and lesser weight to increasing government taxes. Converting such a desirable objective into practical policies is challenging but, nevertheless, in my judgment, attainable.

Congress could, for example, seek to develop a program of spending cuts and tax increases centered around a modified freeze on government outlays at the 1984 level. This approach would freeze only the level of real expenditures and ^{would} permit growth in upcoming years no greater than the rate of inflation. The bottom line is no further expansion—in real terms—of government outlays. This approach would impose no cutback from current spending levels and ^{would} distribute future constraints equitably across all spending programs.

Putting real numbers to this approach provides some interesting results. ^{an} ~~our~~ analysis indicates that, at zero real growth in government spending in 1985, 1986, and 1987, the administration's anticipated 1987 deficit of some \$200 billion would be cut to about half that level. Adding selective tax increases to the mix could reduce that remaining 1987 deficit to

\$50 billion or so, moving the prospects for a balanced budget back into the realm of possibility. Adoption of this approach I have described would offer another very important byproduct: it would reduce government spending as a proportion of GNP from about 25 percent in 1983 to 21 percent in 1987, given reasonable assumptions for economic growth.

I realize, of course, that this approach is only one of many possible solutions, and that difficulties may arise in its implementation. Which reminds me of a story Will Rogers once told during World War I when he heard the U.S. Navy was having difficulties detecting and destroying German submarines: "The solution is simple," he wired the U.S. Navy, "all you have to do is boil the ^{Atlantic} ocean. Since you have the solution," he continued, "don't trouble me about the details."

All of us, of course, must be concerned about reducing the government deficits as well as how they are reduced. Both actions will have an important bearing on the near-term economic situation and the long-run health of the American economy. Whether the approach I have discussed is the best solution, I cannot say. What I can and must say is that the time to act is now. The urgency is clear. We must face the deficit issue with courage and discipline. If we do so, I am confident that the remainder of the 1980's will be a period of economic growth and price stability that we can all experience ^{and enjoy} with a great deal of pride.