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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

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Mr Chairman, members of the Committee, it is a pleasure to appear before you this morning to discuss economic policy, in the context of the broad objectives that are relevant to both of us in our respective spheres of policy making. I have provided our recent Monetary Policy Report and I shall avoid consuming a lot of your time discussing the details presented in that document. I believe that it would be useful, however, if I were to review briefly where the economy has been over the past year and where it appears to us to be going. This may help to bring into focus the challenges that face monetary and fiscal policymakers. Principal among those challenges, in the view of the Federal Reserve, is setting the stage for sustainable, balanced growth, in part by preventing a corrosive inflationary psychology from taking hold. Fiscal as well as monetary policy has a role to play in achieving that objective, and proceeding expeditiously is much more likely to get the job done.

Overall, the past year has been a good one for the economy. In 1988, real GNP grew about 3-1/4 percent, adjusted for crop losses caused by the drought, and payroll employment rose more than 3-1/2 million. Prospects had been uncertain as the year began, given the worldwide stock market break in October 1987, but gradually, it became clear that the economic expansion remained well on track and that market confidence was on the mend. Demand for goods and services was robust, and sizable gains in employment and output pushed levels of resource utilization still higher. The unemployment rate fell to, and then below, 5-1/2 percent, the lowest level since the mid-1970s, and the

average manufacturing capacity utilization rate rose to the highest level since the late 1970s. As these developments unfolded, it became clear that the balance of risks was shifting in the direction of higher inflation. Consequently, the Federal Open Market Committee has applied increased pressures on bank reserve positions, in a series of steps beginning in the spring of 1988 and extending into this year. In addition, the discount rate was raised from 6 to 6-1/2 percent in August, and again last week to 7 percent.

The policy restraint has led to an appreciable rise in short-term market interest rates. Also, growth of money has moderated, as rates on deposits lagged the rise in market rates. M2 and M3 finished the past year around the middle of their 4 to 8 percent annual target ranges, and they have grown relatively slowly in recent months.

Despite tightening money markets, longer-term interest rates have been relatively stable. Yields on Treasury bonds, for example, remained in a fairly narrow range around 9 percent for most of last year and, although rising most recently, are still not much above 9 percent. With inflation expectations apparently fairly stable and the expansion sustained, investments in the U.S. have looked attractive, the dollar's average value against major foreign currencies recovered from the late-1987 plunge and has been relatively stable for many months.

Some of the developments of the past year suggest, however, that we still have work to do if we are to succeed in our task of achieving the goals of balanced expansion and the reduced inflation needed to sustain it. In the area of your direct interest, the federal

budget, the deficit remains large. Meanwhile, private saving remains low. The continued imbalance of domestic saving and investment is mirrored in the persistent large trade and current account deficits.

In addition, although overall inflation last year--in the area of 4 to 4-1/2 percent--was only a little above the general range in which it had fluctuated in the mid-1980s, underlying trends were troubling. At the consumer level, the drought boosted food price inflation in 1988, but this was more than offset in the aggregate figures by a leveling off of energy prices. Now energy prices are turning up. More fundamentally, prices of consumer goods and services other than food and energy accelerated last year and this faster pace extended into January.

Furthermore, some signs have emerged of greater pressures in production costs. Wage increases accelerated toward the end of last year. Moreover, benefits took an unusually large jump in 1988, boosted in part by a sharp rise in health insurance costs and a hike in social security taxes--both of which add to business costs as directly as do wages. Overall, the employment cost index, a comprehensive measure of hourly wage and benefit rates, rose 5 percent in 1988, up significantly from 1987. Materials inputs also were adding to costs, the producer price index for intermediate materials and supplies excluding food and energy has been rising at about a 7 percent annual pace for some time. The large increases in the producer finished goods and consumer price indexes in January could be early warnings that the cost-price process is gathering force.

At the same time, the economy generally remains vigorous. The available data for January suggest that we moved into 1989 with considerable upward momentum. Moreover, widespread inventory overhangs or constricted profit margins, which typically have signaled the last phases of expansions, are not apparent. With the economy already operating at high levels of labor and plant utilization, and given the disturbing signs of strengthening price and cost pressures, the momentum of expansion implies risks that clearly remain on the side of accelerating inflation. It is just such an acceleration that could feed the kind of imbalances that ultimately bring expansions to an end. The Federal Reserve's earlier money market tightening and the discount rate action last week were taken to forestall such imbalances in order to keep the economy on a more sustainable path toward price stability.

The same determination to resist any pickup in inflation and especially to move over time toward price stability shaped the Committee's recent decisions with respect to target or monitoring ranges for money and credit in 1989. To this end, the Committee lowered the range for M2 by a full percentage point to 3 to 7 percent and reduced the range for M3 by 1/2 percentage point to 3-1/2 to 7-1/2 percent. The Committee also lowered the monitoring range for domestic nonfinancial sector debt by 1/2 percentage point to 6-1/2 to 10-1/2 percent.

The Federal Reserve expects its policy in 1989 to support continued economic expansion, even while putting in place conditions for a gradual easing in the rate of inflation over time. However, in light of present conditions, the central tendency of forecasts made by members of the Federal Reserve Board and presidents of Federal Reserve Banks is

for inflation to rise slightly in 1989, with the CPI edging up to the 4-1/2 to 5 percent range

With restraint on inflation requiring that we limit pressures on our productive resources, some slowing in the underlying rate of growth of real GNP is expected in 1989. The central tendency of GNP forecasts for this year of Board members and Reserve Bank presidents is 2-1/2 to 3 percent from the fourth quarter of 1988 to the fourth quarter of 1989, abstracting from the expected rebound from last year's drought losses, real GNP is projected to grow at closer to a 2 percent rate. Net exports are likely to continue to improve as we make further progress on reducing our external imbalances, but this implies the need for counterbalancing restraint on domestic demand. With demands for labor growing more in line with expansion of the labor force, the unemployment rate is expected to remain near its recent level during the course of the year.

Looking beyond a one-year horizon, the primary role of monetary policy in the pursuit of the goal of maximum sustainable growth is to foster price stability. By this we mean establishing an environment where expected changes in the average price level are small enough and gradual enough that they do not materially enter business and household financial decisions. Price stability--indeed, even preventing inflation from accelerating--requires that aggregate demand be in line with potential aggregate supply. Inflation in the longer-term is essentially a monetary phenomenon. But large budget deficits contribute to the problem; they tend to put inordinate strains on financial markets and they directly fuel excess demand on resources. Thus, in the present

circumstances, fiscal policy can help to smooth our progress over the next few years toward better price performance. Prompt and sustained action is becoming increasingly urgent.

The situation today differs markedly from that of the mid-1980s, when the U.S. economy was recovering from a deep recession. Then, with utilization of labor and capital still quite low, we were able to bring these resources back into the production process at a pace that substantially exceeded their underlying growth rates. And in those circumstances, the growth of real GNP could be relatively rapid while the inflation performance was reasonably good.

But as a result of the robust expansion, the U.S. economy has absorbed much of its unused labor and capital resources. No one can say precisely which level of resource utilization marks the dividing line between accelerating and decelerating prices. However, the evidence--in the form of direct measures of prices and wages--clearly suggests that we are now in the vicinity of that line.

Thus, the thrust of both monetary and fiscal policies in the short run appropriately is more toward restraint than stimulus. The extent and duration of the financial market pressures that are likely, until overall demand moderation is achieved, will depend on the size and credibility of deficit reducing measures. In this context, credibility will be much enhanced by a multi-year approach to budget action.

I am mindful that, owing to significant efforts by the executive branch and the Congress, coupled with strong economic growth, the deficit has shrunk from 5 to 6 percent of GNP a few years ago to a bit over 3 percent today. And abstracting from the effects of

economic expansion, the cyclically adjusted, or structural, deficit as a share of potential GNP has fallen by 1-1/4 percentage points from its 1986 peak. Nonetheless, at about 3 percent, this share is still very large. Since the end of World War II, the structural deficit has exceeded 3 percent of potential GNP only since 1983.

I am also mindful that the progress that has been made in narrowing the structural deficit in the past two years is even greater when we look only at the so-called "primary" portion of the deficit, that is when interest costs are removed. Interest outlays, of course, are now very large and their level will remain high as long as our stock of Treasury debt remains large. Nevertheless, growth in the interest component of the budget is volatile. It is spurred by large deficits, but it also picks up when interest rates are rising and then subsides when interest rates come down. For example, annual growth in interest costs averaged around \$13 billion from 1980 to 1985, but since then has slowed to an average of about \$7 billion per year.

The most effective way to keep interest costs down is to forestall another virulent burst of inflation expectations such as we experienced a decade ago. Simple arithmetic tells us that a 1 percentage point increase in actual inflation raises the cost of indexed programs by 1 percent. But if the faster rate of inflation were to become embedded in expectations throughout the financial structure, interest rates, and ultimately federal debt service costs, would rise by more than 10 percent from their current levels. We are fortunate that inflation expectations so far seem not to have worsened, and long-term interest rates have risen little in the past year despite a tightening

in money markets Both fiscal and monetary policies have a role to play in maintaining this situation

For the longer-term, fiscal policy also has a special contribution to make in promoting growth in our production or supply capabilities Reducing the deficit is the surest way to raise national saving, thereby lowering the average level of real interest rates, boosting domestic investment and reducing our reliance on foreign capital The federal deficits of recent years are threatening precisely because they have been occurring in the context of private saving that is low by both historical and international standards In the 1980s, net personal plus business saving in the United States has been about 2 percentage points lower relative to GNP than its average in the preceding three decades Internationally, government deficits have been quite common among the major industrial countries in the 1980s, but private saving rates in most of these countries have exceeded the deficits by very comfortable margins In Japan, for example, about 15 percent of its private saving is estimated to have been absorbed by government deficits, even though the Japanese general government has been borrowing over 2-1/2 percent of its gross domestic product in the 1980s In contrast, about half of private U S saving in the 1980s has been absorbed by the combined deficits of the federal and state and local sectors

Under these circumstances, such large and persistent deficits are slowly but inexorably damaging the economy The damage occurs because deficits, which must be financed regardless of the level of interest rates, tend to pull resources away from interest elastic

private investment. When the pool of private saving is small, federal deficits and private investment tend to be forced into competition and private investment loses. To the extent that more resources are demanded than are available to be financed, interest rates will rise until sufficient excess demand is crowded out of the private sector

In the short run, the Federal Reserve can hold down nominal interest rates but the result largely would be more inflation, with little or no lasting effect on real interest rates and the allocation of real resources. All else equal, any crowding out of productive investment damps the growth of the nation's capital stock and the result is less capital per worker than would otherwise have been the case. This will surely engender a shortfall in labor productivity growth and, with it, a shortfall in growth of the standard of living

Moreover, the higher real interest rates associated with increased borrowing by the Treasury in the 1980s have been associated with a shift in the composition of investment away from long-lived assets, such as factories, and toward computers and other shorter-lived equipment. Evidence points to a recent decline in the average service life of measured consumption spending as well, and suggests a systematic tendency for the average service life of all spending to move inversely with real rates of interest. That is, the higher are real interest rates, the heavier is the concentration on spending that satisfies immediate desires or yields its returns quickly

Not surprisingly, we have already experienced a disturbing decline in the level of net investment relative to GNP, as depreciation has speeded up, reflecting shorter investment horizons. Net investment

has fallen to 4.7 percent of GNP in the 1980s from an average level of 6.7 percent in the 1970s and even higher in the 1960s. The effects of this decline in the net investment share has been offset, to some extent, by increased productivity of certain short-lived capital such as computers, but nonetheless, slower investment has been associated with weak productivity performance.

The U.S. net investment ratio is low, not only by our own historical standards, but by international standards as well. International comparisons of net investment should be viewed with some caution because of differences in the measurement of depreciation and in other technical details. Nevertheless, the existing data indicate that total net private and public investment as a share of gross domestic product over the period between 1980 and 1986 was lower in the United States than in any of the other major industrial countries except the United Kingdom.

Even this U.S. investment performance may not be sustainable. The negative effects of federal deficits on growth in the capital stock in the 1980s may have been attenuated for a while by the strength of aggregate output growth over much of the past six years. Such rates of output growth undoubtedly boosted sales and profit expectations and, hence, business investment, but they cannot be maintained.

Furthermore, net inflows of foreign saving in recent years have been an important addition to aggregate saving. In the 1980s, our ability to tap foreign saving has moderated the decline in the investment-GNP ratio. While the federal deficit rose by about 2-1/2 percentage points relative to GNP between the 1970s and the 1980s, net

inflows of foreign saving have mounted, on average, to almost 2 percent of GNP--an unprecedented level--from close to zero before.

We welcome the discipline and efficiency gains of an open economy, but the continuation of inflows of foreign saving at current levels may be neither desirable nor possible. Evidence for the United States and for other major industrial nations over the last 100 years indicates that, for most countries, such sizable foreign net capital inflows have not persisted, hence, they may not be a reliable substitute for domestic saving on a long-term basis. In other words, domestic investment tends to be supported by domestic saving alone in the long run.

Let me conclude by reiterating that the budget deficit must be brought down. While it is beguiling to contemplate the healthy growth of recent years in the context of large budget deficits, it is fanciful to conclude that these deficits have no adverse consequences. The prospect of a continuing imbalance between domestic saving and investment--with the accompanying constraints on growth and modernization of capital and the substantial reliance on foreign saving--poses risks for the future. Forward looking investors may react to those risks today in financial markets. I do not underestimate the difficult decisions that you must make if we are to achieve the necessary reduction in the deficit. But allowing deficits to persist courts instability in the near term and threatens potentially significant reductions over time in the United States standard of living.