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Testimony by

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before the

Committee on the Budget

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Mr Chairman, members of the Committee, I am pleased to have the opportunity to appear before you once again. As you know, the Federal Reserve's semiannual Policy Report, which was submitted to the Congress last week, provided an extensive picture both of recent economic developments and of the Federal Reserve's policy actions and intentions. Rather than take you through the details of that report this morning, I would like briefly to review some of its main themes and then turn to some of the specific budgetary issues that the committee has asked me to address.

Economic and Monetary Policy Developments in 1989

About a year ago, in early 1989, Federal Reserve policy was in the final phase of a period of gradual tightening, designed to inhibit a buildup of inflation pressures. However, as the year progressed, the threat of accelerating inflation seemed to diminish, and at the same time, there emerged an increasing risk of an undue weakening in economic activity. Consequently, the Federal Reserve in June embarked on a series of measured steps to ease reserve positions, and those steps continued through late last year. Interest rates, which had turned downward in the spring, declined further in the second half of the year, to levels about 1-1/2 percentage points below March peaks. In the event, output growth slowed from the unsustainable pace of the two previous years, but still was sufficient to support the creation of 2-1/2 million jobs and keep the civilian unemployment rate steady at 5-1/4 percent. Inflation was held to a rate no faster than that of recent years, but unfortunately no progress was made in 1989 toward price stability.

The policy adjustments that we undertook over the course of 1989 were more in the nature of a mid-course correction, rather than a reflection of a fundamental shift in policy. Our more basic goals and strategies remained unchanged from what they had been in previous years. The ultimate goal of monetary policy still is that of ensuring price stability so as to promote the maximum sustainable rate of economic growth. Similarly, the strategy for moving toward this goal still is that of restraining growth in money and aggregate demand in coming years enough to establish a clear downward tilt to the trend of inflation and inflation expectations, while avoiding a recession.

Monetary Policy and the Economic Outlook for 1990

Thus far in 1990, monetary policy basically has stayed on an even keel, and the federal funds rate has remained around 8-1/4 percent. Nonetheless, the interest rates on Treasury securities and longer-term private instruments have reversed, on net, some of their earlier declines, reflecting the reaction of investors to stronger-than-expected economic data, a firming of oil prices, and the prospect of greater demands on world saving to support development of the economies of Eastern Europe.

In assessing the economic prospects for 1990 as a whole, the Federal Reserve Governors and the Reserve Bank Presidents foresee continued moderate economic expansion, consistent with conditions that will foster progress toward price stability over time. At its meeting earlier this month, the FOMC selected ranges for growth in money and debt it believes will promote this outcome. In brief, the FOMC reaffirmed the tentative 3 to 7 percent growth range for M2 in 1990 that it set last

July, and it reduced the M3 targets from their tentative range. The M2 range for 1990, which is the same as that used in 1989, is expected by most FOMC members to produce somewhat slower growth in nominal GNP this year. The new M3 range of 2-1/2 to 6-1/2 percent is intended to embody the same degree of restraint as the M2 range, but it was lowered to reflect the continued decline in thrift assets and funding needs anticipated to accompany the ongoing restructuring of the thrift industry. The monitoring range for debt was lowered from a range of 6-1/2 to 10-1/2 percent in 1989 to a range of 5 to 9 percent in 1990.

The overwhelming majority of the Committee believes that money growth within these annual ranges will be compatible with expansion of nominal GNP in a range of 5-1/2 percent to 6-1/2 percent. Expectations of real GNP growth center on a range of 1-3/4 to 2 percent over the four quarters of the year. A slight easing of pressures on resources probably is in store, and inflation pressures should remain contained, even though the decline in the dollar's value since last summer likely will reverse some of the beneficial effects on domestic inflation stemming from the dollar's earlier appreciation. The CPI this year is projected to increase 4 to 4-1/2 percent, as compared with last year's 4-1/2 percent rise.

Risks to the Economic Outlook

Economic forecasting, of course, is not an exact science, and at present, there are obvious risks in the outlook. For example, it is possible that the weakness in economic activity evident around the turn of the year may tend to cumulate, causing members' forecasts about production and employment this year to be overly optimistic. However,

two major depressants of growth now seem behind us. Boeing has returned to full-scale production after last fall's long strike, and in January the auto industry greatly reduced its inventory problems by slashing production and boosting incentives to customers.

Still, we shall need to remain attentive to the risks posed in several areas where the undercurrents have been troubling of late. Profit margins, for example, have deteriorated substantially in recent quarters, and a continuation of this trend could seriously undercut the expansion in capital investment.

Another concern is the increase in financial leverage in the economy. In recent years, business debt burdens have been enlarged through corporate restructurings, and as a consequence interest costs as a percent of cash flow have risen markedly. Among households, too, debt-servicing burdens have risen to historic highs relative to income, and delinquency rates have moved up a bit. Clearly, should the economy fall into a recession, excess debt service costs would intensify the problems of adjustment. While these strains seem unlikely in themselves to precipitate a downturn, they are nonetheless worrisome. Fortunately, the growth of nonfinancial debt has slowed from its frenetic pace of the mid-1980s, and a continuation of this recent trend, along the lines that the FOMC is anticipating, should lessen the financial strains and hopefully the threat to the economy.

The Federal Budget Deficit and Social Security

A risk in the longer-run outlook for the economy--and one that is closer to the day-to-day work of this committee--is the possibility that the federal government might fail to build upon the progress that

has been made to date in moving toward reduced federal budget deficits and eventually, I would hope, toward a position of surplus

I have testified often before committees of the Congress about the adverse effects on our economy of sustained large budget deficits. Put simply, my central concern on this score is that deficits cut into national saving and investment and thereby limit our ability to expand and upgrade the nation's stock of productive capital. It is the size of that stock, together with the quality of the labor force, that ultimately determines overall productive capacity and the future standard of living of our population.

Unfortunately, much of the recent policy debate has shifted away from the budget deficit per se, and toward the financing over time of the nation's social security program. Senator Moynihan has introduced legislation to cut payroll taxes and return the system to a pay-as-you-go basis, and others would like to move its finances fully off-budget. As I stated yesterday in my testimony before the Senate Finance Committee, I am concerned that these changes, if enacted, will ultimately prove counterproductive and will hamper the efforts needed to meet our longer-term fiscal responsibilities. They also would likely increase the difficulty of providing for the needs of an aging population in a way that is equitable across generations. If I may frame the issue in the most basic way, we need to save and invest now in order to have the productive economy that can support a rapidly growing population of retirees two or three decades in the future; pay-as-you-go would not be supportive of that saving-investment relationship, in addition to undermining the notion of equity across generations.

The need to take a long view of the issue arises from the compelling demographic trends that are now in progress. In 1960, there were twenty beneficiaries for every one hundred workers contributing to social security, currently there are thirty. The Social Security Administration--under intermediate economic and demographic assumptions--expects that number to approach fifty by about the year 2025 and to remain at that level at least through the middle of the 21st century.

Assuming that their living standards keep pace with those of the working population, the elderly will of necessity consume a growing proportion of total output in the future. They will finance their consumption out of private and public pensions and by drawing down their own assets. Nonetheless, the goods and services they buy can only come from the output of then-active workers, whose productivity will depend on the investments that we make in capital and new technologies in the interim.

Investment is possible, of course, only if there is saving--the diversion of part of the nation's current production away from consumption, both private and public. The present buildup in the social security trust funds is one source of the needed saving. While, in a sense, these funds exist on paper only, they also are very real claims on future taxpayers and hence on future real output. All else constant, the accumulation of saving in the trust funds increases the likelihood that the real output will be available to meet the needs of retirees without denting the living standards of their children too deeply, if at all. In particular, to the extent that the surpluses are not offset by reductions in the saving of households and businesses or by larger dissaving, that

is, deficits, elsewhere in the federal budget, they should boost investment and thus foster growth of the nation's capital stock. And with more capital per worker than would otherwise be in place, productive capacity and output also will be higher.

At present, the contribution of the trust funds to national saving is being swamped by the large deficits in the rest of the budget. As long as the non-social security deficits remain sizable, Senator Moynihan and others are correct in pointing out that we are doing little to solve the future retirement problem. If, however, actions are taken to bring the non-social security part of the budget into balance, the trust funds no longer will be financing current government spending, but will translate dollar for dollar into national saving.

Ultimately, where saving takes place in the total unified budget--social security or elsewhere--is of secondary importance. What matters in terms of reaching our longer-term growth objective is the government's overall net contribution to national saving. Thus, a chief criterion for evaluating the major proposals regarding social security should perhaps be whether they would in fact help us to achieve the needed saving and investment. For example, is the federal government more likely to shift toward a position of positive net saving if social security is returned to pay-as-you-go financing? Given the large revenue loss implied by the plan, I think not.

A second key criterion for evaluating the proposals is whether they meet the test of equity across generations. Without going into great detail on this point, it would seem to me that the pay-as-you-go proposal again falls short. Indeed, returning now to pay-as-you-go

financing would confer a significant windfall on the "baby boomers" who, in effect, would benefit doubly from the size of their age cohort. Given their numbers, each would make a disproportionately small contribution during his or her working years to the retirement of their elders. Yet, in retirement, each would expect to receive full benefits, which could come only at a disproportionately high cost to their children. The present structure, in my view, is more likely to ensure that an individual's contributions are linked equitably to his or her benefits.

Moving Social Security "Off-Budget"

I also have deep reservations about proposals that would move the social security system fully "off-budget," so that the trust funds would be excluded from the official summary budget figures and from the setting of deficit targets. First, splitting off social security--or any other program--would highlight a distinction that has little macroeconomic or analytical significance. Regardless of which numbers are reported, government saving or dissaving would continue to be well-approximated by the surplus or deficit in the total federal budget as currently defined in the National Income and Product Accounts, a close variant of the total unified budget.

Second, the way budget numbers are presented can influence public perceptions of important fiscal issues and thereby--for good or ill--play a role in decisions that affect the size of the overall deficit or surplus. In particular, I fear that adopting a system that draws attention to the surpluses in the trust funds might foster the illusion that saving already is great enough to meet future obligations

In large part, my concerns are grounded in the analytical issues I discussed earlier. But they are compounded by a technical factor, namely that much of the growth in the trust funds is reflecting interest received from the holdings of government debt. Such intragovernmental interest payments, which will approach 1 percent of GNP in a few years, are both an inflow to the trust funds and an outlay from the general funds, and they wash out when the accounts are consolidated. But, because they result in an overstatement of both the saving taking place in the trust funds and the dissaving elsewhere, they can contribute to a significant misreading of saving trends when either part of the budget is considered in isolation. Moreover, the very growth in anticipated social security surpluses, in large part the result of interest received, is mirrored in the increasing interest costs and widening deficits projected in the non-social security part of the budget. The implied deficit-reduction targets might then be well out of political reach.

Accordingly, I fear that moving away from the unified budget concept will impede the achievement of the sizable deficit reductions that the country so sorely needs. In addition, the inevitable pressures to expand social security benefits or cut payroll taxes if the system were not subject to the discipline of an overall deficit constraint would mount. In the absence of offsetting changes elsewhere in the budget, such actions would reduce national saving and over time worsen the burden on the generation after the baby boom.

Responsible budgeting requires a comprehensive framework for setting priorities and assessing competing claims on national resources. That function currently is filled by the unified budget process. If

deficit targets were to be set exclusive of social security, for example, they could be met--at least in part--by moving related programs into the social security account or by shifting other trust funds off the books. Such actions would shrink the on-budget deficit but would not reduce federal demands on private saving or on credit markets.

The Need for Further Deficit Reduction

Most important, we must not allow the choice of a budget accounting system to divert attention from the pressing need for meaningful deficit reduction, but rather must take actions to set the federal government's claim on saving--however the budget deficit is measured--on a firm downward track. Making a serious commitment to eliminating the unified deficit within the foreseeable future is an essential first step, and meeting that commitment will be a formidable challenge. But it is just a first step. If households and businesses continue to save relatively little, then the federal government should compensate by moving its budget in the direction of greater surplus.

I would remind you in closing that budget decisions often have been shaped by short-run concerns and pressures. Those same decisions, though, many times have had longer-run repercussions that were unintended or perhaps even contrary to original intentions. I hope that in your deliberations on the budget--and particularly in your actions on the social security issue--you will give special attention to the long-run needs of the economy. It is the process of saving, investment, capital accumulation, and rising productivity that largely will determine the economic prospects of the next generation. These goals will be fostered to the extent that you keep us on the path toward reduced government deficits and increased national saving.