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Testimony by

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

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Mr Chairman, members of the Committee, I am pleased to be able to appear here today to offer my thoughts on the economic and fiscal backdrop for your policy discussions

The U S economy has recorded some notable achievements over the past few years, but there is nonetheless much left to be accomplished The fiscal decisions made by the Congress in the next several months will play a critical role in determining the economic welfare of our citizens over the years--indeed, the decades--to come

I perhaps should begin with a brief review of the current condition of the economy In 1994, we had a difficult reversal in monetary policy to navigate The overhang of debt and the strains that emerged among our financial intermediaries, especially out of the commercial real estate collapse of the late 1980s, required a heavy dose of monetary ease beginning in 1989 to alleviate a significant credit crunch The danger of overstaying that policy of ease was clear, particularly as we moved through 1993, but the right time to change course was difficult to determine Judging from the developments of the past year, it appears that our policy reversal last February was timely--but we won't know for sure except in retrospect

There is no question that the past year was one of remarkable progress along many dimensions of macroeconomic performance The official estimates for the fourth quarter are not yet available, but it is clear that real gross domestic product expanded by four percent over the course of 1994--the best gain in some time, and one that surpassed most expectations Importantly, we saw an accelerated expansion of employment as well Cumulatively payrolls have now increased roughly 6 million over the past couple of years, belying in dramatic fashion the notion that had developed earlier in this decade

that our economy had lost its job-generating ability. With the rapid growth of employment, the national unemployment rate has fallen sharply, to less than 5-1/2 percent this past month.

Of crucial importance to the sustainability of these gains, they have been achieved without a deterioration in the overall inflation rate. The Consumer Price Index rose 2.7 percent last year, the same as in 1993. Inflation at the retail level, as measured by the CPI, has been a bit less than 3 percent for three years running now--the first time that has occurred since the early 1960s. This is a signal accomplishment, for it marks a move toward a more stable economic environment in which households, businesses, and governmental units can plan with greater confidence and operate with greater efficiency. When we consider the probable upward bias of the CPI, it would appear that we have made considerable progress toward achieving price stability.

I have stated many times in Congressional testimony that I believe firmly that a key ingredient in achieving the highest possible levels of productivity, real incomes, and living standards is the achievement of price stability. Thus, I see it as crucial that we extend the recent trend of low and, hopefully, declining inflation in the years ahead. The prospects in this regard are fundamentally good, but there are reasons for some concern, at least with respect to the nearer term. Those concerns relate primarily to the fact that resource utilization rates already have risen to high levels by recent historical standards. The current unemployment rate, for example, is comparable to the average of the late 1980s, when wages and prices accelerated appreciably. The same is true of the capacity utilization rate in the industrial sector. It may be that these pressures will lead to some deterioration in the price picture in the near term; but

any such deterioration should be contained if the Federal Reserve remains vigilant

The actions of the Congress and the Administration in the fiscal sphere will also be important to the outlook for prices and the economy  There can be no doubt that the persistence of large federal budget deficits represents in the minds of many individuals a potential risk  While we clearly have avoided it in recent years, history is replete with examples of fiscal pressures leading to monetary excesses and then to greater inflation  Currently, I strongly suspect that investors here and abroad are exacting from issuers of dollar-denominated debt an extra inflation risk premium that reflects not their estimate of the most likely rate of price level increase over the life of the obligation, but the possibility that it could prove to be significantly greater  This inflation risk premium is costly, because it raises the hurdle that must be surpassed when looking at the expected returns on possible investment projects

But the influence of the fiscal imbalance of the federal government on capital formation is broader than that  The federal deficit drains off a large share of a regrettably small pool of domestic private saving, thus contributing further--and perhaps to an even greater degree--to the elevation of real rates of interest in the economy  Admittedly, there is some uncertainty about the causes of what seem to be relatively high real long-term rates around the world, as was noted by leaders of the largest industrial nations at their summit meeting last year  But the vast majority of analysts would agree that in the United States the current sizable federal deficits, and the projected growth of those deficits over the decades ahead, are a significant element in the story

I'm sure that you are aware of the general picture with respect to the flows of saving and investment in the economy, but it may be worth spending a few minutes to review the recent data I've attached a couple of charts to my statement to aid you in following my description As you can see in the upper chart, there has been a dramatic decline over the past couple of decades in the ratio of net domestic nonfederal saving to net domestic product The ratio last year, based on data for the first three quarters of the year was about 6 percent, as compared with more than 9 percent, on average, during the 1960s and '70s In the past few years, net business saving has moved up, as corporate profitability has experienced a cyclical improvement, but the personal saving rate has been running at its lowest levels in nearly half a century The causes of the low private saving rate are hotly debated by economists, and it is fair to say that it is not yet understood Americans have not always been low savers, but--for whatever reasons--that has been the pattern recently and it is a reality with important implications for the financial markets

If we were a high saving nation, we might be in a position to better tolerate the federal fiscal imbalance But, as you can see in the chart, the federal deficit has generally been absorbing half or more of the available domestic saving since the early 1980s Even with the decline in the federal deficit last year, it amounted to almost 45 percent of domestic nonfederal saving

How, then, one might ask, has it been possible for the United States to experience the impressive growth in business fixed investment that it has of late? There are a number of arithmetic components to the answer but I shall focus on two particularly central points The first is that, while <u>gross</u> investment has been

rising rapidly and has been accounting for a substantial share of GDP, net investment has only recently reached appreciable dimensions The difference between gross and net investment is, of course, depreciation, and the fact is that depreciation has been rising steeply because of the shift in the composition of the capital stock toward equipment--especially computers--with shorter useful lives Another ingredient in the reconciliation of the domestic saving and investment balance is saving from abroad--shown in the lower chart Our nation has been running persistent and often sizable deficits in its current account position vis-a-vis the rest of the world, once a leading provider of capital to other nations, we have become a net importer of capital

In today's more open and integrated international capital markets, it is easier to finance investment abroad And economic efficiency may be served by the tendency for capital to flow across borders to where the potential returns on real investment appear highest and the risks the lowest But this does not mean that we should view the pattern of U S external deficits as sustainable in the long run Looking back at the history of the past century or more, the record would suggest that nations ultimately must rely on their domestic savings to support domestic investment

The challenge for the U S over the coming decades is clear We must sustain higher levels of investment if we are to achieve healthy increases in productivity and be strong and successful competitors in the international marketplace To support that investment, we shall need to raise the level of domestic saving Absent a rise in private saving, it will be necessary to eliminate the structural deficit in the federal budget Indeed, it has long been my

judgment that it would be wise to target achievement of at least a modest surplus down the road

If the Congress were to pass a balanced budget amendment, the need for aiming at a structural surplus would become even more important Unless there were a surplus to provide some cushion, the inevitable cyclical fluctuations in economic activity would create pressures either to set aside the requirements of the amendment or to take budgetary actions that are inimical to economic stability It should not be necessary to raise taxes or cut spending in response to a transitory weakening of the economy

I recognize that the achievement of structural balance, let alone surplus, is no small political challenge Moreover, as the Kerrey-Danforth entitlement commission recently documented, the problem that must be addressed is not one with a 2002 end-point The outlook is for a mounting fiscal imbalance during the twenty-first century, given current programs and likely population and labor force trends We should not be seduced by the mounting trust fund surpluses today into thinking that we can postpone dealing with the entitlement gap, the cost of waiting is going to be far more painful adjustments, which could be avoided by moderate actions legislated today to become effective after the turn of the century

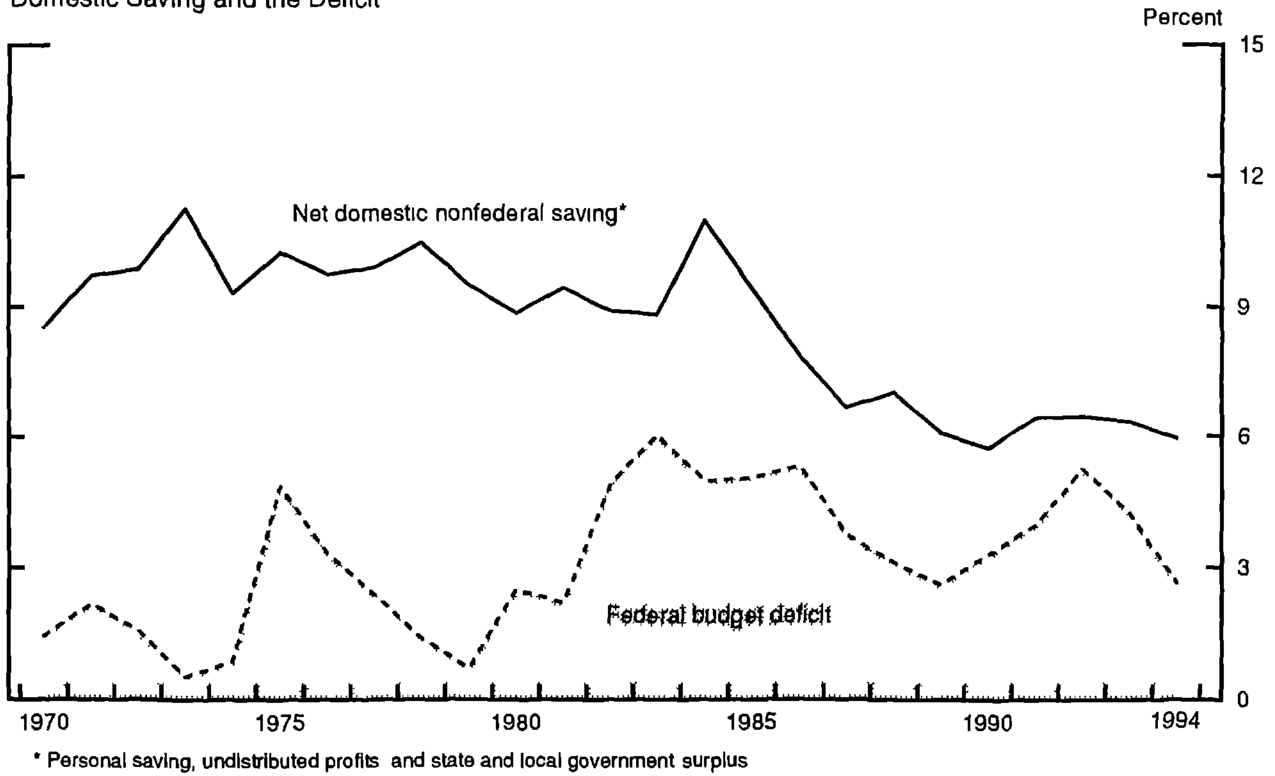
This longer-range perspective obviously has relevance for the tax and spending measures the Congress will be considering Some basic economic principles must be observed, if you are to maximize the federal government's contribution to the fostering of high real incomes and to alleviating the entitlement problem Most importantly, not all taxes or expenditures are equal in terms of their influence on the productive capacity of the economy Although, as I testified recently, I would caution against major changes in budget scoring

techniques at this time, that does not mean that the Congress should not give a good deal of attention to the effects of its fiscal actions on the incentives faced by private decision makers

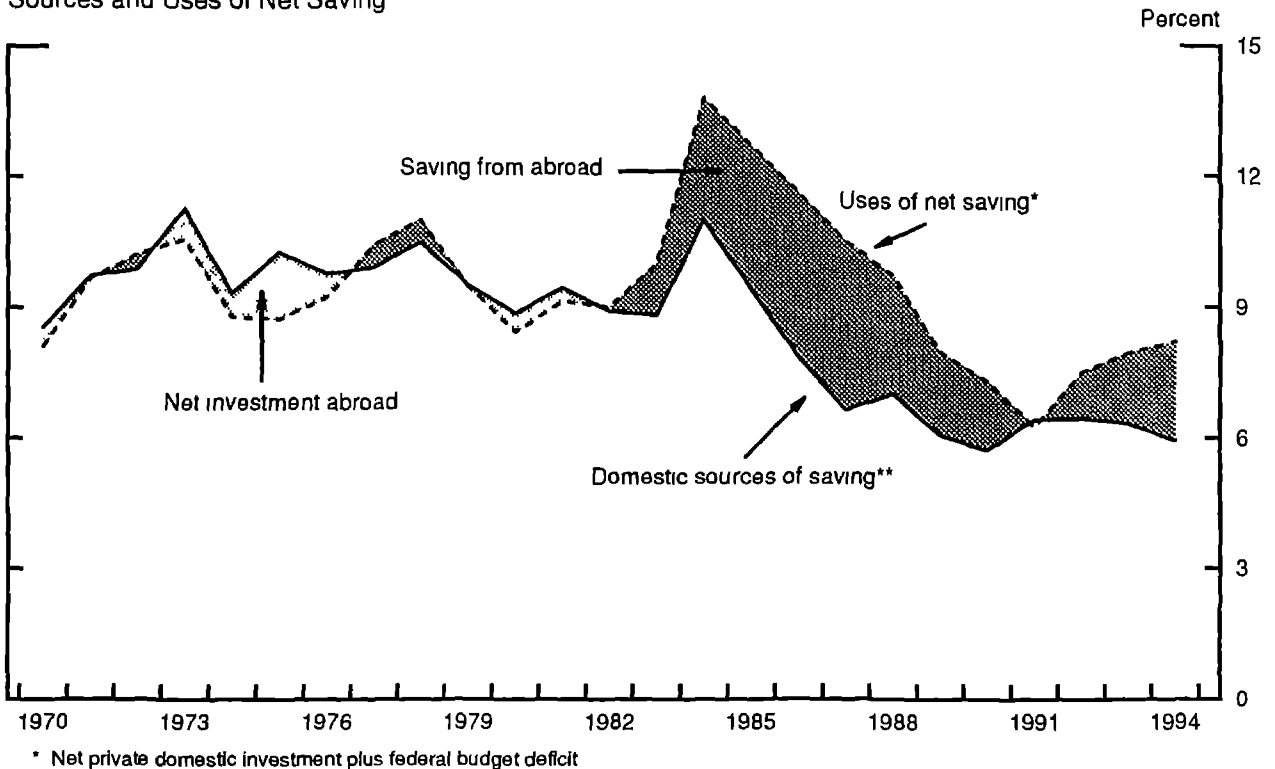
In sum, the recent performance of the macroeconomy has been encouraging But much of the improvement is in the nature of cyclical developments and we all have our work cut out for us if we are to extend these gains and foster long-term trends that enhance the welfare of all of our citizens The central role of the Federal Reserve today is to ensure that our economy remains on a sustainable, noninflationary path For the Congress, a crucial focus should be continuing the process of fiscal consolidation and rectifying the secular shortfall in domestic saving that is limiting the growth of our nation's productive potential

## Saving and Investment

(Percent of net domestic product)




* Personal saving, undistributed profits and state and local government surplus




* Net private domestic investment plus federal budget deficit

** Net domestic nonfederal saving

SOURCE Dept of Commerce, National Income and Product Accounts, table 5 1

Data for 1994 are averages of first three quarters