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Congress of the United States

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June 4, 1980

6/10

The Honorable G. William Miller
Secretary of Treasury
Department of the Treasury
15th Street and Pennsylvania
Avenue
Washington, D.C. 20220

Dear Mr. Secretary:

On behalf of the Members of the Joint Economic Committee, I would like to thank you for taking time out from your busy schedule to participate in our recent hearing on May 28, 1980. Your testimony forms an important part of the record of this hearing and will be of substantial assistance to the Committee.

Copies of the hearings will be sent to you as soon as they have been printed.

Again, thank you.

Sincerely,

Lloyd

Lloyd Bentsen
Chairman

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EXECUTIVE SECRETARIAT
JUN 9 12 32 PM '80
DEPT OF THE TREASURY

Department of the TREASURY NEWS

WASHINGTON, D.C. 20220 TELEPHONE 566-2041

FOR RELEASE ON DELIVERY
Expected at 10:00 A.M.
May 28, 1980

STATEMENT OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY
BEFORE THE JOINT ECONOMIC COMMITTEE

Mr. Chairman and Members of the Committee:

Thank you for providing me the opportunity to appear here today to discuss the current state of the economy. There have been some important developments in economic policy and performance in recent months. These Hearings provide a useful and timely forum for reviewing the significance of these matters.

THE INTENSIFIED ANTI-INFLATION PROGRAM

Earlier this year, while the economy was still rising, domestic financial markets came under intense pressure. In January and February, inflation began to spread beyond the energy and home financing areas. The annualized rate of inflation as measured by the CPI rose from about 13% during all of last year to 18% in January and February. Inflationary expectations intensified greatly. Serious disturbances in domestic financial markets developed in February and early March. Short-term interest rates rose by about 400 basis points, and some long-term financial markets were severely constrained.

In response to the growing threat from inflation, the President announced new actions for intensified fiscal and credit policies, reinforcing the programs of restraint already in place. The steps taken and proposed included major moves in the fiscal and monetary areas. The Administration recognized at the time that this was powerful medicine, but felt, and still feels, that it was required under the circumstances.

In the fiscal area, the FY 1981 budget was revised after extensive consultation with Congressional leadership. The revisions eliminated some $17 billion in programmatic expenditures, bringing the proposed budget into balance. In addition, various measures to improve tax collections and conserve energy were proposed or initiated, resulting in a net surplus for the budget. This shift toward further budgetary restraint required difficult decisions by the Congress and the Administration. However, the actions were recognized as essential for national financial stability and for the long-term health of the economy.

M-508

Strong steps were also taken in the monetary area. Under the terms of the Credit Control Act of 1969, the President authorized the Federal Reserve to exercise new, temporary power to slow the growth of consumer and business borrowing. Implementation of the new measures, in conjunction with the continued exercise of monetary restraint, was remarkably successful in reversing the upward trend of credit demands and inflationary expectations. Short-term interest rates have declined by 800 basis points and more since March 14, long-term rates by more than 200 basis points, and secondary market mortgage commitment rates by about 150 to 200 basis points.

Credit and financial markets are now operating in an orderly and efficient manner. Accordingly, it has already become possible to relax somewhat the credit control measures instituted on March 14.

THE PATTERN OF RECENT ECONOMIC EVENTS

Since mid-March, most of the major economic statistics have indicated appreciably slower activity. It is widely recognized that the economy has entered a period of recession. The move toward recession has been quite steep, as evidenced by recent data on unemployment and industrial production. However, it is impossible to predict the whole course of the recession on the basis of one or two months of statistics. There is always an understandable tendency to assume that the future will merely reflect today's trends. That is rarely a safe assumption.

Similarly, it would be unwise to undertake basic changes of economic policy on the basis of contemporary statistics. Policy always affects the economy with a considerable lag. Most policy changes instituted now would have their major impact on the next recovery, not on the recession. This is largely the case regardless of the precise contours and duration of the downturn. It is, accordingly, very important that we keep monetary and fiscal policies on a steady course, geared to the long-term requirements of economic and financial stability. We have no cause to divert monetary policy from the objective of keeping the growth of money and credit within the established targets, or to divert fiscal policy from a dedicated, persistent effort to restrain the growth of public spending.

These considerations provide an essential frame of reference in reviewing the recent run of weak economic statistics.

- o The unemployment rate rose to 6.2 percent in March and further to 7.0 percent in April. In April, employment fell by about 500,000, the number on layoff mounted sharply, and the percentage of industries reporting increased payroll employment hit a five-year low. Some of the greatest employment impact has been in autos and construction, where the sharpest declines in output may now lie behind us. However, fragmentary data suggest that labor markets softened further in May.

- Retail sales in current prices have declined for three successive months, following a sizable increase in January. Correction to a volume basis is difficult when prices are rising so rapidly, but there has been a sharp drop in sales volume. It is well to recall that monthly retail sales data are frequently subject to large revisions. For example, upward revisions last summer removed the apparent weakness that seemed to have been developing and upon which the projections of recession at that time had come to rest. However, the current decline is more than statistical. To the extent that it reflects a temporary effect from the mid-March program, the recent Federal Reserve relaxation in the consumer credit area should prove beneficial.

- Industrial production has declined for three successive months and the drop of nearly 2 percent in April was the largest since early 1975. Although there are few signs of serious inventory imbalance, new orders for durable goods have weakened in recent months and further downward adjustments in production may quite possibly be in prospect.

- Housing starts averaged slightly above a 1 million unit seasonally adjusted annual rate in March and April, down more than 40 percent from a year earlier. Building permits eased further in April, and housing starts may sink a little further before reviving. However, the decline in interest rates and increased availability of credit should begin to provide a boost for housing before too long.

THE NEAR-TERM OUTLOOK

On the basis of these and other data, it is clear that the economy will register a sharp decline in real output during this second quarter. The more important question in terms of the behavior of output and employment is the pattern during the second half of the year and into next. The weight of economic opinion still expects a moderate recession. For example, four leading econometric models forecast a peak to trough decline in real GNP slightly greater than the average postwar recession, and substantially less severe than the 1974-75 decline.

A recent survey of 42 leading economists at major banks, corporations, and academic research organizations found the average drop expected by that group to be 2.6%, just about the postwar average. The Administration forecast will be revised and updated in line with recent developments, and will be released in July at the time of the Mid-Session Budget Review.

What are the reasons for believing that only a moderate recession is in prospect, rather than a deep decline on the 1974-75 scale? Both financial and real factors point toward a more moderate contraction.

First, in the financial area, it is important to recall that interest rates have come down very sharply from their earlier peaks. Savings flows to thrift institutions have picked up recently and the financial preconditions for an upturn in housing are already being established. A general increase in credit availability and lower interest rates will also provide support for those sectors of the economy that depend heavily upon consumer credit and business borrowing. In the process, the heavy burden that has come to rest upon small- and medium-sized business and agricultural borrowers should gradually be removed.

Second, in the non-financial area, there are still no signs of serious inventory imbalance, and inventory-sales ratios remain at relatively low levels by past standards. Difficulties in correcting for inflation can leave some doubt on that score in terms of inventory volume, particularly in some areas of manufacturing. Still, there is nothing visible to this point which suggests that inventory accumulation is generally excessive. Indeed, cautious inventory policy is one reason why output has fallen so sharply in the current quarter in response to sales declines. In some past recessions, production has continued in the face of a pileup of inventories which only makes the eventual adjustment worse.

Plant and equipment spending plans have continued to show encouraging strength, although it is only realistic to suppose that some modest softening may soon begin to appear. In general, however, businesses are taking a longer view and building the modernization improvements and additions to capacity that will be needed out further in the decade, well beyond the current adjustment.

It seems quite probable, therefore, that the economy is already experiencing its sharpest fall during the current quarter. During the balance of the year, some positive factors should begin to emerge in areas of the greatest current weakness. Auto, housing, and construction activity will not continue to decline at recent rates. Instead, these important sectors of activity are expected to bottom out and begin to post some gains in a lower interest rate environment. It is our best current judgment that the recent drop in the economy will not cumulate much further. Of course, no one can state that with complete certainty. But, on the basis of the information in hand and apparent trends, a modest further decline after the current quarter appears to be the most probable outcome. Needless to say, the current situation is being monitored carefully.

THE INFLATION PROBLEM

Inflation is, and must remain, our number one priority. Already, in the wake of the March 14 measures, there are encouraging signs. The dramatic decline in interest rates in the past two months signals an abrupt drop in inflationary expectations, as well as a softening economy. Sensitive materials prices have fallen sharply in March and April, which also signals a favorable turn in the inflationary process. Because of lags in the process, full results cannot be expected to show through immediately at the later stages of the productive process. However, the consumer price results in April were encouraging, with the lowest monthly increase in more than a year. Admittedly, the favorable producer price index result in April was heavily influenced by falling prices of food and farm products which will not continue on that scale. But there are pervasive signs that the inflation outlook is in the early stages of significant improvement. In May, the members of the National Association of Purchasing Management reported the lowest rate of price increase in three years. This may be the leading edge of things to come in the important area of industrial prices.

There is a dependable and predictable cyclical sequence in costs and prices. It can be seen in every postwar recession and we are beginning to see it now. First, the rate of economic expansion tapers. Second, sensitive industrial material prices begin to fall. Third, after some lag in time, lower rates of inflation are experienced at the final stages of the production process. The first two stages--a softer economy and declines in sensitive prices--are now clearly visible, and the third stage--lower rates of inflation at the consumer level--will become increasingly evident as the year progresses.

The problem is that although every postwar recession has lowered the existing rate of inflation, every expansion in the past two decades has then lifted the inflation rate to a new higher level. This successive ratcheting up of the rate of inflation must be reversed in the interest of long-run economic stability. The fiscal and monetary decisions we make now will be affecting the inflation outlook for some time to come. It is widely felt--here and abroad--that we stand at a crossroads so far as inflation is concerned.

Thus we must not be diverted from our objective of combatting inflation, and be tempted into a policy of excessive economic stimulus. Any premature relaxation of the basic policies of restraint could whipsaw the economy and financial markets. Interest rates and the rate of inflation could easily be driven back up again, with serious consequences for auto production, housing construction and the entire economy. Instead, the proper course to follow is one of continued discipline, to ensure progress in reducing the rate of inflation.

THE BUDGET AND TAX CUTS

The key to the current situation is maintaining close control over federal spending. That now lies well within the reach of the Congress, and you and your colleagues deserve full public support in this crucial effort. If the economy runs close to the path projected in late March and federal spending is tightly controlled, the proposed budget would show a surplus. Even if the recession is a somewhat worse than forecast, the budget proposed by the Administration could still be in balance. In any event, in the present situation, with inflation still deeply imbedded in the economy, it is essential to maintain discipline by controlling federal spending.

Most importantly the steps that were taken on March 14 must be seen as a crucial element of longer-term efforts to bring the growth of federal spending under control. During the 1970's we have had continuous budget deficits in both good times and bad. If we are to improve productivity and bring inflation under control, the Federal government cannot continue to place ever escalating demands on the economy and capital markets. It is essential that we return a larger share of our national output to the private sector where it can be more effectively utilized.

It is far too soon to be talking of tax cuts. Instead, we need to demonstrate our ability through the legislative process to bring expenditures under control. Tax cuts purely for the purpose of economic stimulus and attempted quick fixes for the economy are not appropriate in the current situation. Instead, any tax cuts need to be preceded by clear progress in reducing the rate of growth in federal spending, and justified on the basis of their contribution to longer range goals of productive efficiency and lower inflation rates.

In recent years, this Committee has played an extremely important role in directing attention to the need for a different approach to the economic problems of the 1980's. More emphasis does need to be placed on productive efficiency--the supply-side approach in the current terminology. Greater incentives do need to be offered for saving and investment, and less for immediate consumption. Therefore, we must carefully chart our near-term course in the fiscal area. Otherwise, the latitude required for sensible fiscal action to deal with the deep seated problems of productivity and capital formation could be frittered away through a piecemeal process of tax reduction to encourage consumption.

Our tax system has important effects on our economy, and many of the so-called supply side effects have been unduly neglected in the past. Research in the last few years has sought to address this omission, but the real value of such research becomes evident only when it is integrated into a coherent view of the economy as a whole. Tax cuts affect aggregate demand as well as the composition and growth of "aggregate supply." If we are to fight inflation as well as increase productivity growth, both sides of this equation must be taken into consideration.

CONCLUSION

The need at the present time is to demonstrate our resolve to deal with the inflation problem. What is required is consistency and persistence, coupled with a readiness to adapt sound economic policies to changing economic circumstances. That readiness was demonstrated at mid-March and subsequently. The task remaining is to follow through with steady policies that will guide the economy onto a less inflationary long-term path.

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In the fiscal area, the FY 1981 budget was revised after extensive consultation with Congressional leadership. The revisions eliminated some $17 billion in programmatic expenditures, bringing the proposed budget into balance. In addition, various measures to improve tax collections and conserve energy were proposed or initiated, resulting in a net surplus for the budget. This shift toward further budgetary restraint required difficult decisions by the Congress and the Administration. However, the actions were recognized as essential for national financial stability and for the long-term health of the economy.

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The problem is that although every postwar recession has lowered the existing rate of inflation, every expansion in the past two decades has then lifted the inflation rate to a new higher level. This successive ratcheting up of the rate of inflation must be reversed in the interest of long-run economic stability. The fiscal and monetary decisions we make now will be affecting the inflation outlook for some time to come. It is widely felt--here and abroad--that we stand at a crossroads so far as inflation is concerned.

Thus we must not be diverted from our objective of combatting inflation, and be tempted into a policy of excessive economic stimulus. Any premature relaxation of the basic policies of restraint could whipsaw the economy and financial markets. Interest rates and the rate of inflation could easily be driven back up again, with serious consequences for auto production, housing construction and the entire economy. Instead, the proper course to follow is one of continued discipline, to ensure progress in reducing the rate of inflation.

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Most importantly the steps that were taken on March 14 must be seen as a crucial element of longer-term efforts to bring the growth of federal spending under control. During the 1970's we have had continuous budget deficits in both good times and bad. If we are to improve productivity and bring inflation under control, the Federal government cannot continue to place ever escalating demands on the economy and capital markets. It is essential that we return a larger share of our national output to the private sector where it can be more effectively utilized.

It is far too soon to be talking of tax cuts. Instead, we need to demonstrate our ability through the legislative process to bring expenditures under control. Tax cuts purely for the purpose of economic stimulus and attempted quick fixes for the economy are not appropriate in the current situation. Instead, any tax cuts need to be preceded by clear progress in reducing the rate of growth in federal spending, and justified on the basis of their contribution to longer range goals of productive efficiency and lower inflation rates.

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