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Statement by

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Committee on the Budget

House of Representatives

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Mr. Chairman, members of this distinguished Committee:

I am pleased to be able to participate in these hearings on the Second Concurrent Budget Resolution for fiscal 1980. I might say that on receiving your invitation, I felt it a bit incongruous that my first appearance before a committee of the House as Chairman of the Federal Reserve Board would occur in the context of consideration of fiscal, rather than monetary, policy. But the plain fact is that our nation faces serious problems that require interrelated governmental action, involving all of the main instruments of economic policy. No place are the interrelationships more important than in the area of fiscal and monetary policy. I hope that our dialogue this afternoon will help throw light on the proper role for those instruments in today's setting.

Surveys and other evidence indicate that the most pressing economic concern of the American people today is the persistent and rapid rise of prices. In my judgment, that concern is not misplaced.

As you know, the acceleration of inflation this year can be traced in considerable part to so-called exogenous forces--the rise in food prices, and much more importantly the decision of the OPEC countries to raise oil prices in an amount that, in absolute terms, approaches the increase in 1973 and 1974. But even in appraising these sources of inflationary pressure, I believe it would be wrong to consider them independent of more general inflationary pressures in the United States and elsewhere. For instance, the desire of oil suppliers to recover losses in real income implied by rising prices of other goods and the weakness of the dollar appeared to be one factor contributing to the OPEC pricing decision. Moreover, part of the challenge to economic policy today is to avoid to the extent possible a kind of "leap-frogging" process whereby rising prices and costs in one sector--energy is the notable case--set off a whole sequence of adjustments in wages and prices in other sectors as workers and business engage in a vain attempt to achieve and maintain levels of real purchasing power that simply cannot be sustained in an economy experiencing higher real energy costs and virtually no growth in productivity.

To be sure, the impact of inflation is uneven. Those on fixed incomes suffer, while some people who are well positioned--either by clever design or by good luck--do manage to increase their wealth. Even for the fortunate, however, such a result is at best precarious, frequently built on heavy indebtedness or highly speculative investments. In an environment of virulent inflation, such as we find ourselves in today, there are no reliable havens, and so the discomfort of our citizens is hardly surprising.

Even these capricious effects on individuals and the related concern reflected in the surveys do not capture the insidious and debilitating effects of inflation and inflationary expectations on our economic performance and growth prospects. It is not entirely a coincidence that we can observe in these recent inflationary years a declining tendency in the profitability of investment. Calculations differ because of the accounting problems associated with changing prices. However, one estimate indicates that the annual after-tax return on corporate net worth, measured, as it reasonably should be, against the replacement cost of inventories and fixed assets, has averaged 3.8 percent during the 1970s, a period characterized by rapid inflation, as compared to 6.6 percent in the 1960s. At the same time, the uncertainty about future prospects associated with high and varying levels of inflation tends to concentrate the new investment that does take place in relatively short, quick pay-out projects. Or firms may simply delay investment commitments until the pressures of demand on capacity are unambiguously compelling--with the result that capacity pressures can become strong even before the labor force is fully utilized.

In other areas, inflationary expectations are reflected in a diversion of energies into essentially speculative activities--ranging from the "froth" of investing in art objects to the considered purchase, at the expense of heavy indebtedness, of larger or second homes as an inflation hedge. When returns from these activities are often judged greater than from usual patterns of work and saving, normal incentives are plainly distorted in a manner inconsistent with orderly growth.

Another obvious result of our distressingly poor price performance has been the recurrent weakness of the dollar in foreign exchange markets. During much of 1978, the cumulating decline in the value of the dollar abroad added an important further element of uncertainty and instability to the United States and other economies. Following the vigorous program introduced in November of last year, the dollar rose somewhat against other major currencies, helped by an improvement in our current account and by indications of a relative strengthening of economic expansion abroad. But the value of the dollar internationally began to be questioned again as the trend of U.S. inflation worsened noticeably, and as many of our trading partners acted forcefully to retard inflationary tendencies in their own economies. Although the situation in exchange markets appears to have stabilized recently, that stability ultimately rests on our ability to cope with inflation.

We need to deal with inflation and a vulnerable dollar in the context of the slowing in domestic economic activity that developed in recent months. A moderation in the growth of aggregate demand was welcome this year--even essential--if the economy was to avoid the kind of pressures on capacity that could only aggravate inflationary forces. Policies of monetary and fiscal restraint were directed toward that aim. Now it is apparent that the drain of purchasing power implicit in the sudden run-up in our oil import bill and in energy prices generally--combined with the actual and feared shortages of gasoline--has led to a contraction of real incomes and final demands. During the second quarter, real gross national product fell, primarily reflecting a drop in consumer spending, and further declines in some areas of business activity continued into the summer. With sales falling, businesses have experienced some involuntary accumulation of inventories--most strikingly in the auto industry, but to a lesser degree in other sectors as well.

Our reading of the most recent economic indicators suggests that a correction of these inventory imbalances is well under way. Orders have been reduced, production schedules have been cut back, and hiring has slowed. These adjustments need not by themselves set in motion a deep or prolonged contraction in activity. Indeed, while the inflationary process itself has introduced important new uncertainties, some of the economic and financial dislocations and imbalances that usually have presaged severe cyclical declines have been avoided. To be sure, the transfer of income to foreign oil producers will continue to exert a depressing effect on aggregate demand over the near term. But the position taken in the Board's midyear report to the Congress--that the economy should grow moderately in 1980--still seems reasonable.

In the present circumstance, we need to be especially cautious in interpreting any business forecast; there are vulnerabilities in the present situation on the downside, and there is also the possibility that the downturn will prove shorter and shallower than many now expect. The shaping of policy must appreciate and take account of the risks on both sides. For instance, the traditional response throughout the postwar period to any prospect of declining production and rising unemployment has been a sharp shift in monetary and fiscal policy toward expansion and the enhancement of aggregate demand--even at the risk of adding to inflation. A decade or two ago, with prices historically fairly stable, that risk was discounted. But now we have to face squarely the adverse consequences of premature or unduly large moves to stimulate the economy. In exacerbating the already serious problems of inflation and the dollar, such moves would also feed back on the underlying problems of investment, productivity, and growth.

Some observers have suggested that this situation presents an intractable dilemma for policymakers: the need to sacrifice one set of economic goals in the pursuit of another. But this dilemma seems to me more apparent than real. Even in the relatively short run, premature stimulative actions could well prove ineffective rather quickly, and even counterproductive, as their force is dissipated in higher prices rather than real growth--in more uncertainty, rather than less. Ultimately the perceived "trade-off" between unemployment and inflation would only be worsened. That is the lesson of the 1970s, not just in the United States but elsewhere.

I think we would all agree that, over the years, labor and product markets have developed an increasing sensitivity to inflation. Expectations about inflation are an important factor in wage bargaining, in price setting for many goods and services, and certainly in interest rates. The plain danger is that actions rightly interpreted as doing little or nothing toward dealing with our underlying persistent problems of productivity and investment, but all too likely to produce more inflation, will in fact have only a small and short-lived expansionary effect, regardless of their intent. Our ability to avoid future instability in employment, or to deal with chronic unemployment in urban areas and among our young, would be damaged, not enhanced.

Similar behavior dominates the foreign exchange markets: exchange rates usually respond quickly--and sometimes excessively--when incoming economic data or news about policy actions alter the outlook for inflation. Adverse repercussions on the dollar generate in turn new uncertainty and inflationary pressures, partly because of the direct effects on costs of imports and partly through the reduced competitive restraints on prices of domestically produced goods. We have tasted too much of the vicious circle of domestic inflation and external depreciation to want to see that pattern repeated. The dangers would extend beyond the domestic economy. Because of the dollar's role as an international store of value and medium of exchange--a role we cannot simply shrug off or dismiss consistent with our own interests and those of our trading partners--its instability could pose a major threat to the world system of finance and commerce and even to our political leadership.

Obviously, then, our current economic difficulties are tightly interwoven. They will not be resolved unless we deal convincingly with inflation. Progress won't come easily or suddenly; among other things the adjustment in prices of energy and petroleum-based products is far from complete. But what we can do--what we must do--is begin the process and prevent the inevitable rise in real energy prices from fanning out into an acceleration of general inflation.

Monetary and fiscal policies are not the only tools we should bring to bear. But both monetary discipline and fiscal discipline--policies that are seen to be disciplined--are absolutely basic to restoring and maintaining a greater sense of stability.

For its part, the Federal Reserve intends to continue its efforts to restrain the growth of money and credit, a growth that in recent months has been excessive in terms of our own 1979 objectives--objectives that have only recently been reviewed by our Congressional oversight committees. Those efforts, combined with heavy credit demands, have had the visible consequence of some increases in short-term interest rates as the availability of reserves has been limited through open market operations. But I would also note that the impact on longer-term securities markets, generally considered more important for business decisions, has been small. We seem to have here an illustration of the more general proposition that actions to deal with the sources of inflationary pressure should over time have a constructive influence in restoring more stable and healthier financial and economic conditions.

I frankly do not know whether needed restraint on monetary growth will be reflected in further increases in short-term rates; that will depend on the course of economic activity, credit demand, and other factors. But I do know that credit flows at present are generally well maintained, and no sustained decline in nominal interest rates can reasonably be expected in the absence of a discernible slowing in the underlying trend of inflation.

Meanwhile, the moves in the direction of fiscal restraint by the Congress and the Administration have been a key ingredient in setting the stage for a successful anti-inflationary effort. Substantial progress has been made in the past year toward reduction of the federal budget deficit. Potentially more significant, in terms of the longer-range outlook, is the sense of greater control on spending that has been achieved by the efforts of this Committee and others.

Of course, the deficit has remained high, even after years of business expansion, and reductions in spending relative to GNP have been modest so far. Moreover, with the economy likely to be sluggish in the months ahead, the operation of automatic stabilizers could lead to a temporary widening of the gap between expenditures and receipts. That in itself need not be disturbing--if budgetary decisions do not seem to throw us off the track of restoring budget balance and restraining expenditures as the economy picks up. However, legitimate doubts would be raised by sizable new spending programs not matched by savings elsewhere; indeed, such an approach would directly challenge our ability to eliminate future deficits and could only add to skepticism over the commitment to contain inflation. Similar doubts would be aroused by a premature commitment to tax reduction--welcome as such reductions would be over a period of time. I believe that we should be particularly wary of tax reductions that might have a transitory effect in adding to the purchasing power of consumers but that would accomplish little or nothing toward stimulating investment, cutting costs, or improving work incentives. For these reasons, the members of the Federal Reserve Board believe both the Administration's budget proposals and the Second Concurrent Budget Resolution recommended by the Senate Budget Committee represent a broadly appropriate and desirable commitment to hold the line on spending, to avoid premature tax cuts, and to contain the size of the deficit.

As I noted earlier, a broad range of uncertainty must be assigned to any forecast of economic events, particularly in view of the obvious vulnerability of the economy to a variety of exogenous forces. In that connection, we cannot entirely exclude the possibility of recessionary tendencies cumulating and intensifying, even if it would be wrong to have current policy decisions dominated by that single possibility. There is much more danger--in terms of aggravating the inflationary momentum--in prematurely anticipating the most unfavorable hypothesis than in dealing in the most orderly and effective way we can with the clear and present fact of inflation.

Should economic trends develop in a clearly unfavorable direction and action come to be needed to deal with sharp declines in output and employment, it would be crucially important that those actions be integrated with the longer-term needs of the economy. Specifically, any fiscal actions should be designed to minimize any inflationary impact in the short run while helping to deal positively with some of the sources of inflationary pressures in the long run. Cost-cutting and incentive-building tax reductions broadly meet this criterion; few spending programs do. We need to give much more weight than in the past to the need for both tangible capital formation and research and development, for these activities underlie productivity growth.

I need not emphasize that even well designed tax reduction--reduction that could have important payoffs over time in improved productivity and reduced cost pressures--has a cost in terms of transitional deficits and increased competition in the credit markets. Tax reduction, however desirable over time, needs to be earned by a sustained commitment to spending restraint. Prematurely timed or poorly structured, the potential gains could be swamped by adverse effects in an inflation-prone economy.

The monetary and budgetary policies that I have discussed seem to us in the Federal Reserve essential if our commitment to controlling inflation and stabilizing the dollar is to have meaning. They would lay the groundwork for changing expectations about inflation in the short run and for renewed growth and stability over a longer period of time. I would emphasize that other efforts, in the areas of wage-price policy, regulatory reform, and the encouragement of market competition, are important as well. We also must deal with our energy situation, one that today leaves us vulnerable to foreign sources of supply. But none of these policies, important as they are, can substitute for commitments to fiscal prudence and restraint on the money supply.

Public concern is high--but out of that concern grows awareness of the pressing need to solve our inflationary problem. Therein lies our opportunity. I would suggest the American people are coming to understand that there are no easy answers, but that failure to act consistently and forcefully can only lead to worse results, both for the vitality of our economy and for our world leadership. Your budget making is quite clearly a key element in the process.