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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Taxation and Debt Management

of the Committee on Finance

United States Senate

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Mr. Chairman, I am pleased to appear before this Subcommittee to discuss the proposed increase in the limit on the public debt. I should like to focus my opening remarks on the broader issues of federal finance highlighted by the need to raise the debt ceiling. It is important that we understand the implications of deficit finance in the current economic environment. It is also important that we recognize that the conventional measures of the budget and the national debt significantly understate the scope of the government's presence in the credit markets. I want to emphasize the need for effective control of federal financing activities as we attempt to solve the nation's serious economic problems.

Fighting inflation stands clearly as the most urgent task of economic policy today. The ominous acceleration of price increases over the past year has given rise to a sense of real crisis. There is now, I believe, the resolve to resist the inflationary momentum that has been building for so long. The Federal Reserve, for its part, has moved decisively to reduce progressively the growth of money and credit. That effort seems to me an essential component of any effort to restore price stability. To that end, we have taken a series of actions to improve our control over the growth of the monetary and credit aggregates.

Last October 6, in addition to raising reserve requirements and the discount rate, we made a change in our operating procedures. We believe that these measures contributed importantly to our success in bringing about a moderation of monetary expansion in subsequent months. A second major set of actions was announced March 14. I refer to the program of special credit restraints that was established in conjunction with the Administration's anti-inflation effort. While it is too early to evaluate the effects of our latest actions -- which are supplementary to our basic effort and temporary -- I fully expect that they will reinforce the measures taken last October, while tempering the degree of pressure that might otherwise be placed on some sectors of the economy dependent on bank credit.

Monetary policy cannot -- without peril -- be relied on alone to halt inflation. The other major tools of public policy must also be brought to bear on the problem, with fiscal policy playing a central role. Thus, I am greatly encouraged by the efforts of the Administration and the Congress to achieve a balanced budget in the 1981 fiscal year. I frankly would urge an even earlier start -- doing what we can right now -- and I would personally encourage the Congress to work with the Administration to implement even deeper cuts in spending than are currently in prospect. But what is essential is that there be a clear commitment to the consistent application of budgetary discipline in the years to come, and a reduced rate of expenditure increase should be the centerpiece of that discipline. Such a policy, complementing consistent control of the money supply, would provide a credible basis for anticipating sustained progress against inflation.

That we are faced again with an imminent need to raise the debt ceiling is a sobering reminder of how difficult it has been in practice to achieve a reasonable balance between federal outlays and receipts. It would be unreasonable and unwise to insist that the government budget be in balance or surplus every year in all economic circumstances. But deviations should be the exception; and it would be naive to ignore the obvious bias toward deficit that has been apparent in the conduct of fiscal policy. The record speaks for itself: the federal budget has been in deficit in every one of the past 10 years, and has been in surplus only once during the past 20 years. Most recently, the Federal Government has continued to run huge deficits even in the late stages of one of the longest expansions in the post-war era.

In retrospect, it is apparent that there has been a tendency in the development of fiscal policy to focus more on the possibility of weakness in economic activity than on the danger of greater inflation. In my judgment, the resulting pattern of budgetary decisions has played a major role in both accommodating and intensifying inflationary pressures. It also should serve as a warning in the present circumstances. The current resolve to cut expenditures and balance the budget in the next fiscal year is to be applauded. But history strongly suggests that it will be difficult to sustain budgetary discipline. This lesson must be kept firmly in mind if the sacrifices made in the short run are to produce lasting benefits.

The financial counterpart of persistent budget deficits has been, of course, a mushrooming of the federal debt. The federal debt subject to statutory limits reached $845 billion at the end of February, almost three times its level in 1960. This enormous expansion of debt has serious consequences for economic performance. Federal borrowing absorbs scarce private savings and intensifies pressures in financial markets. When productive resources are being pressed by strong demands for goods and services and overall credit supplies are tight, the government pre-empts the loanable funds that would otherwise be available to finance private capital formation.

The adverse consequences of reduced private capital formation are difficult to exaggerate, given the fundamental importance of investment in determining the pace of productivity growth. While the economic profession has yet to arrive at a fully satisfactory explanation of the substantial slowing in productivity growth in the 1970s, there is no doubt that one important element was the falloff in the expansion of capital stock at a time when labor force growth was accelerating. Increases in output per hour worked are the basis of a rising standard of living. When productivity lags and the economy grows more slowly, aspirations for higher living standards are frustrated.

Competition for shares of real income and inflationary pressures are aggravated. In short, persistent deficits and increases in government debt tend to inhibit capital formation and productivity growth, further contributing to the wage-price spiral.

The potential for federal financial activity to displace other borrowers extends well beyond the growth of debt associated with persistent budget deficits. Outlays of off-budget agencies have grown to be very sizable in recent years. Such outlays were just under $12-1/2 billion in 1979 and are expected to be $15 billion in 1980. Off-budget outlays largely take the form of direct government loans and are financed by the Federal Financing Bank (FFB). Ultimately, however, the FFB obtains its funds from the Treasury, and thus the deficits incurred by off-budget agencies directly increase federal borrowing needs. In addition to its direct loan programs, the Federal Government also provides financing assistance through loan guarantee programs. Outstanding loans guaranteed by the Federal Government totaled $228 billion at the end of last year.

As intended, the direct government loans and loan guarantee programs allow certain targeted activities to be financed under more favorable terms than would otherwise be possible. The provision of such credit assistance to achieve particular social and economic objectives certainly is a legitimate activity of the Federal Government. It must be kept in mind, however, that the supply of credit is limited, and that government assistance to particular sectors may make it more difficult for other groups to obtain credit to finance worthwhile and productive investment.

I am increasingly concerned that such government financing activity is not under effective control. Over the past 10 years, federally guaranteed loans have somewhat more than doubled. Yet, at present, there is no comprehensive framework for evaluating these activities. Only a small portion of this credit activity is ever considered in the Congressional deliberations on the budget. Loan guarantees do not involve the expenditure of funds, and consequently are not reflected in the unified budget, except to the extent that appropriations are required to cover the cost of defaulted loans.

In sum, there are serious shortcomings in the current process of reviewing federal financing activity. I would wish, therefore, to reiterate the position of the Board, expressed in recent testimony by my colleague, Governor Teeters, that a federal credit control budget should be established along the lines suggested by the Administration, or preferably, more comprehensively.

It also seems to me that the issue of the debt ceiling should be more closely linked to the budgetary review process. The statutory limit on federal debt is not reasonably a separate device for controlling the budget. The determination of the budget and the debt ceiling are more logically a simultaneous process. The present system carries with it the potential for contradictory actions on the part of the Congress. Indeed, twice in the last two years, the authority of the government to borrow expired briefly, causing the postponement of Treasury security auctions, delays in the mailing of federal checks, and the threat of default on federal checks already in the mail. Lengthier delays in extending the debt limit could have produced much more serious consequences, including ultimately a default on maturing government securities.

To minimize the possibility of such problems, I strongly recommend that the Congress consider setting the debt ceiling in the process of approving the budget. At present the Congress already must pass resolutions setting recommended levels for the debt when it votes on the budget. Essentially, I am seconding the Treasury's recommendation that such resolutions be given the force of law.

I am, indeed, somewhat encouraged by the strides that have already been made in gaining better control over the budgetary process. There seems to be a genuine opportunity to balance the budget in the coming fiscal year. We can do better. For one thing, we should bring federal financing activities under better control. More generally, we must demonstrate a commitment to reduce inflation by consistently striving for budgetary discipline in the years ahead.

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