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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

House of Representatives

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I am pleased to respond to your invitation to participate in this hearing to help clarify, as best I can, the issues before you and the Congress in setting budgetary priorities during a period of economic uncertainty.

As you are well aware, the current recession developed much later than the great majority of economic forecasts had suggested, and then broke with more force than had been generally anticipated. Indeed, the abrupt fall in output this past spring about matched the record postwar decline that occurred in the first quarter of 1975 and was about as large -- in percentage terms -- as we have typically had over the course of an entire recession. More recently, the rate of decline in economic activity has moderated. Some indicators can even be interpreted as suggesting the recession could be relatively short-lived.

However, the recent record of economic forecasting is warning enough of the uncertainties inherent in judging with precision fluctuations in economic activity. We do know that, whatever encouragement we can draw from some of the most recent data on the near term outlook, the fundamental forces accounting for some of the persistent problems of the economy remain -- poor productivity and low savings, adjustments to sharply higher costs of energy, and most importantly, the uncertainties and distortions associated with strong underlying price pressures. It is the strength of those forces that seems to me to dictate the main outlines of economic policy.

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I understand and share the immediate concern about recession. But I am even more concerned that we shape policies that also look toward the medium and longer term needs of the economy, lest we inadvertently extend and repeat the pattern of low productivity, rising inflation, and economic instability.

In that connection, I am convinced the stability and vigor of our economy will not be restored over time unless the ominous cycle of rising levels of inflation in successive periods of expansion can be brought to a halt. We would neglect that prime objective of economic policy at our peril. For that reason, the Federal Reserve has been, and will continue to be, guided by the need to maintain financial discipline, a discipline reflected in reduced growth over time of the monetary and credit aggregates.

As recently as July, the Federal Reserve reaffirmed its ranges for the monetary aggregates that call for a deceleration of money growth in 1980 from the pace during the preceding year. The tentative monetary ranges established for next year specify slightly lower growth. I am glad to say that this approach was supported by the relevant Congressional committees.

In general terms, the targets for growth of the monetary aggregates are designed to encourage progress toward price stability. At the same time we would, of course, like to see resumption of sustainable economic growth. In the short run, monetary policy alone cannot guarantee that happy combination of events. Technically, the supply of money tends to be related to nominal GNP, and our targets are consistent with a number of

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possible combinations of real growth and inflation. If inflation tends to decline, the prospects for satisfactory growth consistent with the targets will be greatly improved. Conversely, to the extent other policies and behavior -- public or private -- are tending to reinforce inflationary pressures and credit demands, more of the available money supply would be absorbed in financing price increases rather than real activity. Inflationary expectations would tend to keep interest rates higher than otherwise.

We cannot escape that problem by simply increasing the money supply to accommodate a higher rate of inflation. The result could only be to prolong and intensify the inflationary process, in turn undermining the recovery and setting the stage for intensification, rather than resolution, of our economic problems. That is why I believe it so important that all our policies take account of the need to break the insidious pattern of rising rates of inflation in successive cycles -- a pattern that, I would remind you, has been accompanied by higher levels of unemployment rather than lower.

During the spring and early summer, we began to see some slowing of price increases from the exceptional pace of earlier this year, and a zero inflation rate was reported for July in the consumer price index. The concerns over a virtual explosion of inflation rife last winter have rightly receded, an important factor in the sharp declines in interest rates in the spring. Nevertheless, we have to recognize the improvement so far has been related largely to transitory or short-term factors -- a softening in markets for energy and some industrial commodities, favorable supply conditions for food in the spring, and the easing of mortgage

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interest rates. As you know, food prices have more recently turned up again, and the last reported producer price indexes make less happy reading.

More important than these short-term fluctuations, which are part of the normal dynamics of our complicated economy and reflect in part weather and external developments, the "underlying" or "core" rate of inflation -- which is roughly determined by trends in compensation and productivity -- has tended to rise in recent years. With no productivity gains to offset wage increases, that core rate appears to be in a 9 to 10 percent range; if anything, the growth rate of labor costs appear to have drifted higher in the first half of this year. There is no doubt that concern about this inflationary performance, and fears of the future, are a powerful force holding interest rates up at present.

One important means of dealing with these wage and cost pressures is to improve productivity. Productivity gains can directly offset cost pressures; over time, moreover, productivity gains are the only lasting source of increases in per worker real income, and rising real income should in turn reduce the pressure for "catch up" wage gains or anticipatory pricing. In that connection, a strong case can be made for tax reduction as a means of increasing investment and productivity. Federal taxes already account for an historically large proportion of income, and in 1981, this ratio could be pushed sharply higher as a result of sizable increases in taxes for social security, the windfall oil profits tax, and the inflation-induced bracket creep in the individual income tax. In my view, the size and the composition of the tax

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burden do have adverse implications for business investment, for costs, and possibly for incentives to work and save.

For those reasons I welcome the emphasis in recent tax proposals to deal as a matter of priority with taxes on investment. But at the same time, tax reduction -- whether to assist productivity or to support purchasing power -- has effects on revenues and the budgetary position that we cannot ignore. If we try to do so, the adverse effects may more than offset the good. For that reason, I believe tax reduction must be conditional on progress in restraining expenditure growth.

As you know, I fully supported the strong effort to restrain expenditures last winter by the Budget Committees in the House and Senate, and to aim for a balanced budget. With the economy slumping, a budgetary balance is obviously beyond reach today. But government spending will probably be smaller as a result of that Congressional and Administration effort, and the central point is that restraint must be maintained if we are to have a credible opportunity to achieve budget balance in a more fully employed economy.

I am frankly concerned about the size of the expenditure increases projected in the latest official estimates. I recognize a sizable part of those increases represent a normal, and potentially reversible, response to cyclical developments in the economy. Nonetheless, the trend of our spending, taking account of national security and other needs, plainly limits the amount of tax reduction that would be prudent. To the extent that budgetary discipline is suspended in the face of economic slack, the room for tax reduction

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could shrink, even to the vanishing point. Indeed, programs and policies interpreted as exacerbating and prolonging the inflationary process can be counterproductive even in terms of economic stimulus, in part through the expectational effects on financial and other markets.

Consequently, I cannot emphasize too strongly, if we are to plan on tax reduction, the need to exercise strong restraint over spending and to contain the stresses and strains a huge deficit could place on the economy -- especially on financial markets. These markets -- both domestic and international -- have become so sensitized to inflation and so wary of deficits that the anticipation of excessive spending and more inflation can be as damaging as the reality in driving interest rates higher at home and the dollar lower abroad.

The desirability of tax cuts -- particularly those without clear rationale in terms of investment and productivity -- also is contingent on the general performance of the economy. Our inability to predict the economic future accurately has been demonstrated often enough. Experience indicates numerous well-intentioned programs of economic stimulus have been ill-timed and excessive. Currently, we are arguably near a turning point. One of the questions in that respect is whether the pressures of government financing -- or the inflationary outlook generally -- may dampen the recovery of significant sectors of the economy, such as housing or automobiles. It would be ironic, indeed, if over-exuberant planning for tax reduction -- designed for stimulus - had adverse effects in terms of inflationary expectations and

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financial markets, interfering with the natural recuperative powers of the economy.

I have made the point in earlier testimony that I would want to defer any decision about the appropriate scope of the tax reduction at least until after the election, when, among other things, we can have a clearer view of the spending priorities of an Administration and a Congress for a period of time ahead, a matter that inevitably can only be clarified after November. I realize you do not have the luxury of foregoing a budgetary resolution. What seems to me important is that the resolution susta spending restraint. Conceivably, sufficient restraint could be achieved to make it prudent to provide room for limited tax measures aimed at the priority need to stimulate business investment, reduce costs and enhance productivity growth. However, I am doubtful at best that that restraint could be carried to the point of justifying general tax reduction programs at this time, pending reassessment of the budgetary and business situation around the turn of the year.

Crucial as monetary and fiscal policies are, many other elements of public and private policy are directly relevant to the prospects for moving toward lower levels of inflation as the economy recovers. With productivity actually declining recently, and faced with higher energy prices, the hard fact is the real income of the average worker will decline. That fact cannot be changed by pushing up nominal wages and prices; the result is

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more inflation, not more real income. The gains and losses may be reshuffled, but the real performance of the economy will probably be adversely affected in the process. In the context of any given set of monetary and fiscal policies, the end result will be fewer jobs, not more.

Of course, it is much easier to analyze the problem than to find practical means of slowing the wage-price treadmill rapidly and effectively, when fears of inflation are so deeply embedded. I believe it is clear from what I have already said that the answer cannot simply lie in passively accepting whatever increase in the money supply would be necessary to accommodate the inflationary process. To the contrary, I would hope and expect that firm financial discipline -- monetary and fiscal -- can be one factor encouraging moderation in business and labor behavior. The possibility of relating tax reduction to wage restraint has occasionally been raised, but it seems to me to have received less attention than the question may deserve. I have not been convinced that a formal, detailed program for linking income restraint to tax reduction, as some have proposed, is practical. Nevertheless, before sizable reductions in personal taxes are considered by the Senate and the House, I believe an opportunity presents itself to explore carefully, with business and labor, the need for a commitment to restraint in wages and pricing during this crucial period in the interests of the economy as a whole, and their own economic well being.

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I have spoken many times of the need to develop concerted policies in other areas to help us to achieve and reconcile our economic goals. We need to reduce our dependence on foreign oil -- a matter not unrelated to tax policy. We need to attack those elements in the burgeoning regulatory structure that impede competition or add unnecessarily to costs. And, I believe, it would be a serious mistake to seek relief from our problems by a retreat to protectionism, which would risk weakening the forces of competition, reduce the pressures on American industry to innovate, and undermine the attack on inflation.

We are now at the critical point in our efforts to reduce inflation while returning the economy to a path of healthy and sustainable growth in the 1980s. We must not sacrifice that opportunity by neglecting the need to place our immediate actions in the context of a coherent longer-run program. One essential part of that program requires firm discipline over the growth of money and credit. Control over spending and the Federal deficit is another. Any tax reduction that can be fitted into that context should be responsive to the fundamental needs of our economy to improve productivity and investment, to contain costs, and to improve incentives.

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