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Statement by

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before the

Committee on Appropriations

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I am pleased to participate in this hearing and to outline some of the key issues for economic policy in 1981 and beyond. The inauguration of a new President and the installation of a new Congress provide a prime opportunity to reassess Federal budgetary trends, and in particular, the role that fiscal policy can play in solving the economic problems that confront us. Coming from the Federal Reserve, I will naturally want to focus special attention on the interrelations among fiscal policy, monetary policy, and conditions in the capital markets.

I have spoken often of the importance of breaking the inflationary momentum that grips our economy. That seems to me the pre-eminent objective of economic policy, partly because prospects for sustained growth rest on success in that effort.

As you know, inflationary pressures remain intense today even though the level of economic activity is little higher now than it was in early 1979, unemployment has been high for almost a year, and appreciable excess capacity persists in many important industries. Indeed, the underlying inflation rate today appears at least as high, and probably higher, than a year ago. Declining productivity has compounded the effects of growing wage increases in pushing up unit labor costs. Moreover, as we look to the months immediately ahead, the possibility of a renewed surge in energy and food prices represents a serious source of concern.

I believe that the public is acutely aware of the dangers of continuously escalating prices and recognizes that combating inflation must be our top economic priority. That perception is an important first step in moving toward price stability. But the general perception will be meaningless unless it is accompanied by a sustained commitment to concrete policies that will, in fact, reduce inflation, even when those policies entail risks and strains for particular groups or for the economy as a whole in the short run. Given the deeply ingrained patterns of inflationary behavior and expectations that now characterize our attitudes and our institutions, we should not assume that changes in those behavior patterns or expectations will come easily. To underestimate the challenge would be to miss the opportunity to set the economy on a new direction. In the wake of missed opportunity we would only face more prolonged, and ultimately more painful, adjustments.

Conversely, if we truly face up to the job, and successfully turn the corner on inflation and inflationary expectations, then I believe that progress will come more readily. The baleful interactions among inflation, low savings, congested capital markets, low growth, deteriorating productivity and budgetary deficits can potentially give way to a benign process of mutually reinforcing growth, investment, and a return to price stability.

As part of that process, the Federal Reserve has been, and will continue to be, guided by the need to maintain a disciplined monetary policy. Our various "targets" for monetary and credit growth are an important means of expressing that intent.

At the beginning of last year, we adopted objectives for the monetary aggregates that were generally agreed to be broadly appropriate with the need to encourage a return to a more stable economic environment. Over the course of the year, growth of the various measures of money and credit was -- on balance -- close to or only slightly above the upper ends of the announced ranges. With the quick and surprisingly strong recovery in business activity in the latter part of the year, the expansion of money and credit was not sufficient to meet all the demands for financing the combination of real growth and rising prices. Even though monetary aggregates for a time exceeded targeted growth, interest rates returned to historically high levels, placing heavy burdens on the more credit-sensitive areas of the economy and threatening the continuation of the recovery.

Looking at that immediate situation, the point can and has been made that high interest rates and strained capital markets may dim prospects for business expansion and private job creation that would otherwise be desirable. Certainly, housing, some smaller businesses, and others particularly dependent on credit feel particularly strong pressures.

But the problem cannot usefully be viewed in the single dimension of monetary policy, and our sights must extend beyond the next few months.

I see no alternative to continued restraint of excessive money and credit growth if we are to break the inflationary momentum. If that momentum is not broken, interest rates will remain high indefinitely. In that connection, expectational factors can be particularly important. To the extent that economic trends and public policies are perceived as consistent with more inflation rather than less and government financing needs are expected to remain high, savings are discouraged and borrowing encouraged. In an already inflating economy, the net result of trying to bridge the gap by excessive money and credit creation would be to validate the inflationary expectations and inflationary trends that give rise to the problems in the first place. The way to get interest rates lower, and keep them there, is to deal with inflation first.

The events of the past several months demonstrate clearly that heavy reliance on monetary policy in that effort focuses the immediate strains and risks on financial markets and those most dependent upon them. Strong complementary actions in other areas are essential for a balanced effective program to produce the earliest possible impact on inflationary behavior and to clear the way for sustained, full, and broad-based expansion in real activity.

The first -- and perhaps the most important -- of these other instruments is the fiscal posture of the Federal Government. As recently as last spring, a substantial effort was made by the Administration and the Congress to reduce the growth of expenditures and to restore budgetary discipline. In spite of that effort, trends in Federal spending continue to exceed growth in the inflating nominal GNP. For instance, the budget submitted by the outgoing Administration projected Federal spending (including off-budget outlays) of over 24 percent of the GNP during the current fiscal year, fully one percentage point higher than last year and appreciably above any earlier year of the post-war period. To be sure, a significant part of this year's higher spending and the enlarged deficit reflects higher unemployment. But the underlying trend reflected in "out year" budget projections -- which have almost always fallen short of subsequent reality -- remains excessive, even without taking account of needed tax reductions.

I see no escape from the central proposition that, to make room for tax reductions and for private credit demands -- both required to support economic growth and productivity gains -- Federal expenditures and off-budget credit programs will have to be cut back sharply from current projections.

The problem is not limited to the current fiscal year. The time has come to take a hard look at the "built-in" spending programs that are not readily -- or at all -- controllable by the annual appropriation process. This process of spending

control should begin immediately, with the aim of achieving very substantial gains over a period of several years. The need is all the more urgent in the light of the broad consensus that defense spending must rise.

I know the task is difficult in the best of circumstances -- and those difficulties are multiplied by the institutional setting in which you work, where the focus has been more on the current or next fiscal year effects of appropriations than on the longer term budgetary consequences of the so-called entitlement programs.

What must justify the effort is its central importance. I have some sense of what you know more directly -- that every Federal program has some legitimate purpose and a well-entrenched constituency; that particular groups -- including those that clearly support reductions in the aggregate -- will argue that its program is the exception; that one man's concept of fluff and fat is another man's perceived sacrifice; that a general consensus on a broad objective can dissolve in the process of allocating cuts. I also know that it is easy (and right!) for me to say that the decisions about what should be cut back are properly yours and the President's, not mine. But I also must emphasize that, in the interests of a healthy economy and moderating tensions in financial markets, I see no alternative to large spending cuts.

In that connection, I need not linger over the desirability of prudent tax reduction and restructuring. As things stand, Federal taxes are absorbing a rising share of aggregate personal

and corporate income, and the sheer size of that tax burden adds to costs and impairs incentives. But I must convey to you my conviction that decisions for substantial tax reduction must not run ahead of the harder decisions to achieve large cuts in spending programs. If these decisions are not in harness, the potential benefits of tax reduction could all too easily be swamped by inflationary forces and congested credit markets, damaging the very incentives and investment sought. And, appraisals of the beneficial effects of tax reduction on economic growth, and therefore the revenue "feedback," need to be realistic in the light of experience.

Beyond the budgetary process itself, but often related to it, are the myriad of government programs that tend to raise costs or insulate sectors of the economy from market forces. Indeed, I believe a substantial part of the inflationary bias built into our economy over the past quarter century comes from such programs.

I recognize that some of those programs reflect a conviction that, within our market-oriented system, those experiencing financial and business reverses not entirely or primarily of their own making are entitled to an economic "safety net." There is a legitimate view that -- at a time of economic pressure and strain -- the dependence of one sector of the economy or another may at times require cushioning pressures of the weakest links in the system so that its problems do not infect others. Other programs reflect valid concerns about the

environment, health, and safety. What is so necessary is to achieve a better balance between those continuing objectives and the requirements of a well-functioning competitive economy, and particularly examination of those regulations and policies that may not even serve well their immediate objectives.

Accomplishing these goals will require an enormous effort by the Congress and the Administration in the months and years ahead. We are talking about changing behavior patterns that are grounded in an assumption that inflation will continue -- an assumption that has been years in the making. Achieving that change is not a simple process. But neither is it beyond our collective capacity, working together with the understanding of what is at stake. The result will repay the effort many times over. It is that understanding that is critical to success, and that I hope will underlie your deliberations and actions in the weeks and months ahead.

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