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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 be here today to discuss our shared concerns about the interrelationships of budgetary and monetary policy. I have the distinct impression that there is a broad consensus about the appropriate goals for economic policy, including the priority need for a marked reduction in inflation as a prerequisite for sustained growth in employment, productivity, and real income. The difficult task we have before us is to translate that general consensus into effective action. The Administration has provided a firm lead in its program for economic recovery. I hope that our dialogue today will further contribute to this process by enhancing mutual understanding of our needs and policies.

In principle, it is broadly accepted that the objective of monetary policy must be to restrain growth in money and credit as part of the process of turning back inflationary forces. Indeed, the effort to control inflation has, until now, often seemed to rely almost exclusively on monetary policy. The consequence has been higher interest rates and greater strains on our financial fabric,and on industries particularly dependent on credit markets,than would otherwise be necessary.

There is also understanding that no escape from those financial pressures can be found in expansive monetary policies. In the end, such an approach would only aggravate the very

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inflationary forces that underly so much of the difficulties in the economy and in financial markets. What is necessary is that other policies -- including most specifically the fiscal decisions that are the province of this Committee -- be in harmony with the need to deal forcefully with inflation. In particular, I cannot stress too strongly the need to change the strong upward trend in Federal spending that has characterized recent years.

As you are painfully aware, inflation is not yet receding. We did avoid a further ratcheting up in the general rate of inflation last year, despite another quantum jump in oil prices and strong wage pressures. But that "holding action" has been accompanied by little growth, on balance, in economic activity since 1979, and unemployment is high in important sectors of the economy.

Moreover, inflationary expectations are now deeply embedded in public attitudes, as reflected in the practices and policies of individuals and economic institutions. After years of false starts in the effort against inflation, there is widespread skepticism about the prospects for success. Overcoming this legacy of doubt is a critical challenge that must be met in shaping -- and in carrying out -- all our policies.

Changing both expectations and actual price performance will be difficult. But it is essential if our economic future is to be secure.

Monetary policy inevitably has a crucial role in this effort. It must be -- and must be seen to be -- consistently

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directed towards curbing excessive growth in money and credit. Such restraint is inherent in the Federal Reserve's commitment to reduce the growth of money and credit over time until inflationary pressures subside.

Our specific objectives for monetary and credit growth in 1981 were presented to the House and Senate Banking Committees last month. Without going into detail here, these targets point toward further reductions in the growth of money and credit as compared with the rates of increase in other recent years. In the context of strong inflationary pressures, the targets are intended to be restrictive, as they necessarily must be if there is to be a winding down of the inflationary process.

The need for that basic discipline is common to virtually all schools of economic thought and is, as you know, recognized in the Administration's program for economic recovery. The only issue for debate is how vigorously to proceed.

I might also note that our efforts to keep money growth within acceptable bounds will at times be associated with substantial variations in short-term interest rates in response to shifting credit demands, changes in economic activity, or other factors. Increases or declines in short-term rates -- such as have occurred recently -- are sometimes cited as an indication that Federal Reserve "policy" is changing. But those interpretations are misleading. Those interest rate fluctuations typically reflect shifts in credit

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demands and expectations about inflation and economic activity, which can be volatile, and should not call into question our intent to maintain firm control on monetary growth over time. At times, with inflation strong and the economy expanding, restraint of money and credit expansion may well be associated with high interest rates. But those high interest rates are fundamentally a reflection of the strength of inflation and excessive credit demands; they are not in themselves a policy objective. Indeed, over time restraint on money creation should lead to lower, not higher interest rates, as inflation subsides.

It is clear that the process of reducing inflation through monetary restraint can be painful. It implies less money and credit than is needed to support both the current rate of inflation and sustained growth of real activity. Obviously, the faster that inflation subsides, the greater will be the scope for real gains in economic activity. Monetary policy is, of course, designed to encourage and speed this disinflationary process. But if strong cost pressures from wage settlements, energy prices, or other factors persist or accelerate, strains in financial markets will be greater than otherwise, and real activity is likely to remain constrained. All of that points up the importance of other aspects of economic policy and, in particular, the stance of fiscal policy, the principal concern of this Committee.

The Congress and the Administration are now in the process of making a fundamental reappraisal of the conduct of economic policy. The focus of this effort is the Administration's far-reaching proposals for tax cuts, spending reductions, and

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regulatory reforms. The design and success of the program that emerges is critical to the effort to reduce inflation and increase productivity. I personally am encouraged by the initial Congressional reactions to the new direction proposed by the Administration. There appears to be broad recognition of the nature and urgency of our problems and a willingness to bring to bear a new discipline on spending.

This Committee and others will be debating, as you must, the Administration's proposals. In my view, it would be inappropriate for me or the Federal Reserve to inject ourselves into consideration of the precise form of the budget and tax cuts. Rather, I will confine myself to some general comments about the overall thrust of the budget, and how it inter-relates with the problems and purposes of monetary policy.

In that connection, I want to emphasize that my judgments about appropriate budgetary decisions are not heavily dependent upon a particular forecast about economic activity over the next year or two. Of course, the actual budget results for any fiscal year are in fact sensitive to what is happening with respect to prices, unemployment, real income, and interest rates. But our ability to forecast these variables with precision is demonstrably limited. The range of uncertainty is probably increased at a time of major new policy initiatives and possible "external" shocks because past relationships may be a less reliable guide to the future.

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I know you unavoidably will need, in the end, to make precise numerical assumptions in presenting the budget. But rather than suggesting precisely which assumptions are most plausible for fiscal 1982, I believe it more important to emphasize certain basic and longer-run considerations that seem to me valid whether or not growth or inflation turns out moderately better or worse next year than a particular forecast might suggest. I emphasize the point because the problems with which we are dealing are fundamental; they have arisen over a long period of years; and the solutions must be geared to the fundamentals rather than to cyclical concerns, that to a considerable degree are unpredictable in any event. Put another way, I believe we have a clear idea of where the major economic and financial risks lie, and now the task is to minimize them.

Among the fundamental considerations is the desirability, from the standpoint of economic performance over time, of tax reduction. I have little doubt that the growing level of taxes -- relative to GNP approaching the highest level in our history, even during war -- is a factor both in slowing growth, adding to inflationary cost pressures, and distorting savings and investment decisions.

There is no dispute among economists that the particular structure of taxes can have important effects on incentives to work, to save, to invest, and to bear risk. Consequently, to the extent taxes can prudently be reduced, it is important

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that the reductions be designed in a manner to maximize the beneficial effects on incentives. That is why, as I understand it, the Administration has urged that tax proposals involving other considerations be deferred.

What limits our ability to reduce taxes is, of course, the potential budgetary deficits -- deficits that are already likely to be large in the period immediately ahead. Given restrained growth in money and credit, the sale of Treasury securities to finance a deficit curtails the availability of funds to private borrowers, potentially reducing needed productive investment. As the deficits are larger, the threat of extraordinary pressures and strains on interest rates and financial markets increases, and the more difficult it is to control the money supply and inflation. The risks are increased to the extent deficits are incurred when the economy is expanding.

That is why I emphasized at the start the critical importance of cutting back as sharply as possible the inexorable rise in Federal spending. In my judgment, that must be the keystone in the arch of any new approach to economic policy -- a policy that can offer a real prospect of success in dealing with inflation and in laying the groundwork for lower interest rates and more vigorous growth.

In approaching that job, we should bear in mind the seemingly chronic tendency for actual Federal spending to exceed official estimates for future fiscal years. Recent

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experience in that regard has been particularly disturbing. We have usually been overly optimistic in our assumptions about economic circumstances, overestimating growth in the economy or underestimating inflation. To be sure, there will always be errors in estimates, and in some circumstances -- an unexpected recession, for example -- a temporary automatic response of expenditures to deteriorating economic conditions may be appropriate. But not all the unanticipated expenditure increases reflect new economic circumstances; the tendency has been to add or enlarge programs and to underestimate their expenditure requirements. If history is any guide, spending tends to exceed intentions as we move from initial budgetary planning to actual results, and I would suggest you appraise the risks in that light.

I would also be cautious, in assessing budgetary prospects, of the view that increased business and personal savings should be looked to as a means of financing a deficit. Savings are exceptionally low today. I share the hope and expectation that new economic policies and declining inflation will restore a more adequate level of savings. But those savings, as and when they materialize, are urgently needed to finance productive investment and housing -- they should not be dissipated in financing prolonged huge budgetary deficits.

For all those reasons, considerations of general economic policy suggest <u>all</u> the risks lie on the side of

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cutting expenditures too little. I am acutely aware of the difficulties and constraints that you face -- the need to increase defense spending, to protect the truly needy, to pay interest on the national debt, and to maintain strength and continuity in other essential programs. In the broadest sense, those security, social, and other requirements ultimately limit what can be done to reduce spending. But looked at from the standpoint of the need to reduce inflation and encourage economic growth, you cannot, in my judgment, cut too much. Every added dollar of spending cuts will provide more assurance that needed tax reduction can be accomplished within a prudent budgetary framework. Every step toward a reduced budgetary deficit can only help head off tension in financial markets and make room for private investment.

You know how difficult it has been in practice to achieve a reasonable balance between Federal outlays and receipts. The record is clear; there has been only one surplus in the Federal budget in the past 20 years. We will not reach that objective in fiscal 1982. But we must not continue to rationalize decisions that can only have the effect of sustaining huge deficits indefinitely.

In setting the 1982 budget, we can meet two crucial criteria that seem to me implicit in the Administration's thinking. First, we can cut back the upward trend in spending and significantly reduce the ratio of spending.to

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the GNP. Second, we can put the budget on a path that realistically will produce balance and move into surplus as the economy returns to levels of unemployment and capacity utilization characteristic of most recent years.

You are well aware there are no easy choices before you. But the wrong choice, it seems to me, would be to let this opportunity pass to change the direction of Federal spending. Then, the risk of prolonging inflation and unsatisfactory economic performance and of great strains in financial markets would be aggravated. Surely, there is room for cutting if there is the will, and the Administration's proposals for specific cuts over a broad array of programs point the way.

The Federal Reserve has an indispensable role to play in dealing with inflation. To be effective, we must demonstrate that our own commitment is strong, visible, and sustained. That is our intention. But the effectiveness of our effort depends on complementary fiscal, regulatory, and other government policies. I feel sure that we are in fundamental agreement about those concepts. What remains is to confront unflinchingly the hard decisons that this effort will require.

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