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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

United States Senate

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I am particularly pleased to be here today. It provides, first, an opportunity to congratulate this Committee on its leadership in measures already adopted to begin the process of controlling the steeply rising trend of Federal spending. Looking ahead, I would like to consider with you the efforts that must continue to be made to restore sound, non-inflationary growth to our economy, recognizing the relevance to that objective of healthy capital and money markets.

You are as aware as I of the difficulties in the current economic scene. Many individuals, businesses, and municipalities are facing substantial stresses and strains, and much of the discontent focuses on the persistence of extraordinarily high interest rates.

In this situation, we must not lose sight of the fundamental cause of our current predicament: the buildup of inflation and inflationary pressures over many years. A lasting resolution of our economic problems generally, and the interest rate problem in particular, will be found only in success in the battle against inflation. Should we be diverted from that objective, our economic and financial problems will only be aggravated.

The fact is we can now begin to see significant signs of progress in the fight on inflation. The various measures of prices this year have all shown somewhat slower rates of increase than in the preceding two years. While some sectors of the economy are indeed under heavy pressure, the overall level of economic activity is higher, and the rate of price increases lower, than almost all economic forecasters thought probable at the beginning of the year.

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Under the circumstances, it may be frustrating to observe the skepticism and doubts reflected in the recent performance of many financial markets. I believe that skepticism will be proved unwarranted. But what is important in that connection is not my belief or yours, but whether we persevere in policies and actions to justify confidence.

The markets are reacting to the harsh reality of continuing inflationary momentum and heavy current and prospective financing demands. More broadly, they reflect the hopes and forebodings of millions of citizens about the future as they make investment decisions. The hard fact is that repeatedly in the past efforts to combat inflation, to curb deficits, and to limit monetary growth were not sustained over a long enough period to bring success. For all the signs of progress today, we need to recognize that, in some respects, the toughest part of the job remains ahead. We also need to recognize there is no safe, painless alternative to the fiscal and monetary objectives we have set for ourselves; indeed, a sense of retreat would not only aggravate the present problems, but could set back the prospects for restoring growth and stability for years to come.

In the area of monetary policy, I think we are all now generally agreed that inflation will not be brought under control without persistent restraint on growth in money and credit. History provides ample evidence that inflation will not subside, and price stability be maintained, without confining the longer-term trend growth of money and credit to amounts consistent with the growth of output. The Federal Reserve has stated its intention

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to pursue such a policy of restraint. As I reported to the Congress in July, we are reasonably on track currently in achieving our reduced money supply objectives this year. We also recognize, in the years ahead, growth in money and credit will need to be further reduced.

In a situation of inflationary momentum and rising costs, monetary restraint, however necessary, is not an easy process. I must also quickly point out the alternative of trying to accommodate the provision of money to inflationary demands could only be more painful over time. We have learned the hard fact that we cannot live comfortably with inflation, that it only undermines our growth potential, and that it will inevitably bring higher, not lower, interest rates.

What we as a government can do is to relieve the pressures on the credit markets, on monetary policy, and on the economy growing out of our fiscal imbalance. As you are well aware, the Administration and the Congress have taken very large steps, in a remarkably brief period of time, to stabilize and reduce the Federal tax take relative to national income. Indeed, as a percent of GNP, revenues should fall by over 2 percent by 1984, reversing the climb to a post-war peak of over 21 percent in recent years. Looked at in isolation, the new tax law offers the prospect over time of improving the environment for business and personal savings and investment. Investment incentives should be strengthened by the capital cost recovery provisions; the lowering of top bracket marginal

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tax rates and the accompanying reduction of capital gains taxes should help to increase the availability of venture capital; and incentives for productive activities -- for saving, working, and risk-taking -- should all be enhanced.

But we cannot escape the fact that tax changes also involve a large loss of revenue in the years immediately ahead; receipts will be about $80 billion less in 1984 than at the existing GNP-tax ratio, and about $150 billion lower than the pre-existing tax rates would have produced at the same level of income. There are, of course, two sides of the budgetary equation, and we start from a position of a large deficit. Without spending restraint in place alongside tax reduction, the Federal Government will continue to pre-empt a large fraction of one of our scarcest resources -- savings. Then, the most credit-dependent sectors of the economy would inevitably remain particularly vulnerable, just as they are today, in effect left with the crumbs from the national economic table. And even businesses directly benefitting from tax reduction and new incentives will find themselves in strong competition with the Government for available savings, blunting the very objectives sought.

The problem -- which, of course, manifests itself in exceptionally high interest rates -- will not, and can not, be solved by inflationary money and credit creation by the Federal Reserve. The net result of that would be to incite further borrowing and ultimately damage savings as well.

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Nor can a "solution" be found by trying to ration scarce credit and savings by some arbitrary and ultimately unenforceable system of credit controls; indeed, efforts by borrowers to protect themselves and consequent market disruptions would likely only make the situation worse.

What can be done -- and done consistent with our short and longer-run objectives -- is to provide assurance that the Federal fiscal position is indeed clearly on the track toward balance. On the spending side of the fiscal equation, the Congress and the Administration have begun an effort unprecedented in my Washington experience to scale back the growth of Federal outlays. At the same time, it is evident that, given the size of the tax reduction, the spending cuts made so far -- large as they may be in historical perspective -- have been only a "downpayment" on those needed to bring expenditures into alignment with the receipts side of the budget. The Administration budget estimates presented to the Congress during the debate on the tax bill always assumed a large amount of as yet unspecified cuts for the fiscal years ahead. Those estimates have themselves been based on relatively optimistic economic assumptions. As I understand it, in voting tax reductions by large majorities, the Congress accepted the challenge of cutting the spending suit to fit the revenue cloth.

Failure to carry through on efforts to slow the growth of Federal expenditures in amounts commensurate with the need would leave us with the reality and prospect of large deficits

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in relation to our savings potential, with its inevitable implications for financial markets and for sectors of the economy dependent on credit. The harsh fact is that the past track record has not been encouraging; the Federal budget has been in deficit in all but one of the past twenty-one years. More often than not, deficit forecasts have been successively enlarged with each new estimate. It is doubts arising out of this experience that, it seems to me, lie behind much of the market skepticism.

More generally, our patience has been tried by efforts to deal with inflation, and past efforts have been relaxed prematurely. Doubts that inflation will be brought under control continue to act perversely as an incentive to borrow; for their part, lenders remain reluctant and want to protect themselves against the prospect of declines in the real value of their assets. Thus, even in conditions in which the economy as a whole is sluggish at best, we have had strong inflation-generated demands for credit pressing against constrained supplies, which only serves to push up interest rates.

Aside from these expectational effects, the direct impact of budget deficits on the market seems to me evident in the data. Net of capital consumption allowances -- that is, the amount necessary to maintain the present stock of business investment and housing -- we generated about 170 billion dollars of savings last year, reflected largely in

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business retained earnings, personal savings, and state and local pension fund contributions. That is what we have at current levels of income to add to our plant and equipment, to inventory, to housing -- and to finance the Federal Government deficit. As shown on Table I, the financing required by the combined unified deficit and off-budget Federal financing totaled over $80 billion, nearly one-half of the total available.

The point is often made that, relative to our GNP, our budget deficits are relatively small by international standards. So they are. But so are our savings, and it is the relation between the two that counts. (See Table II.)

I would quickly add that the effect of a deficit on the economy and capital markets can only be judged in the context of a particular economic situation. There may be relatively little risk of "crowding out" in a period of high actual or potential savings, falling investment demands, adequate home-building relative to demands, and low interest rates. But that is surely not the circumstances of today, in which we have a clash in the market among competing demands.

The essence of my comments today is simple. There are intense financial pressures on many firms and individuals. We would all like to see relief from those pressures as soon as possible. We don't want them to recur. Ultimately, that is dependent on dealing with inflation -- and policies that do not recognize that reality can only prolong the pain, whatever their surface appeal.

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Dealing with inflation, in turn, requires restraint on money and credit growth. Entirely consistent with such restraint, reduction in Federal deficits -- and the perception that those reductions will be continued until balance is reached -- will greatly help to relieve market pressures and to make room for the investment and housing we want.

I can appreciate the irony, from your point of view and mine, of some recent financial market developments. Amid encouraging signs of progress on inflation, with your strong efforts toward expenditure control, with firm monetary restraint in place, the markets seem to be expressing doubts. But after all, Americans have not seen for many years a successful fight on inflation or balanced budgets or so massive a tax reduction. A lot of bets on the future are still being hedged against the possibility that you, and we, will not carry through.

We have been at critical junctures before in the fight on inflation -- and the bleak reality is we have not had the foresight and the courage to stay the course. That is why we have gradually come into the grip of the most prolonged and debilitating inflation in our entire economic history. The lesson is clear -- we must carry forward on the basic fiscal and monetary course upon which we have embarked. To do less would not only throw aside the signs of progress we are seeing, it would inevitably make even more difficult an attack on inflation in the future, with all that would imply for our economy and our society.

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We mean to do our part, and I am sure we can count on this Committee to carry on the effort it has so well started.

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Table 1

SOURCES OF SAVING IN THE UNITED STATES
(National Income and Product Accounts Basis)

	1975-79		1980	
	Billions of dollars	Percent of GNP	Billions of dollars	Percent of GNP
Gross national saving[1]	353.3	18.1	457.2	17.4
Capital consumption	201.0	10.3	287.2	10.9
Net national saving[1]	152.3	7.8	169.9	6.5
Personal	82.7	4.2	101.3	3.9
Corporate	47.0	2.4	44.3	1.7
Other	22.6	1.2	24.3	.9
Memo:				
Federal government deficit[2] (unified plus off-budget)	-60.9	-3.1	-83.4	-3.2

1. NIPA gross saving excluding NIPA federal surplus (or deficit) plus net foreign investment (sign reversed).

2. The federal deficit on an NIPA basis averaged $425 billion in 1975-79, 2.4 percent of GNP, and was $61.2 billion in 1980, 2.3 percent of GNP. The off budget deficit, alone, averaged 14.3 billion in 1979-80, and was $15.3 billion in 1980.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts. All rates are calculated as the average value of item for the period, divided by the average value of GNP. Details may not add to totals because of rounding.

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Table 2

INTERNATIONAL COMPARISONS OF SAVING
(U.N. System of National Accounts Basis)

	1975-1979 Average	
	Gross Saving	Net Saving[1]
	--Percent of gross domestic product--	
Canada	20.8	10.1
Japan	32.0	19.0
France	22.8	11.6
Italy	22.2	12.2
Germany	23.0	11.8
United Kingdom	18.0	6.8
United States	17.2	4.9

1. Gross saving less capital consumption allowances.

SOURCE: Organization for Economic Cooperation and Development, National Accounts of OECD Countries, 1962-1979 (Volume II). All country data are reported according to the United Nations System of National Accounts, which differ from the United States NIPA. Details may not sum to totals because of rounding.

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