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Remarks by

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We are deluged these days -- and we have been for some time -- with learned, and not so learned, analyses about the budgetary problem. There has been a lot of plain confusion about the facts and the outlook -- and the reality is that any budgetary projection cannot approach the mathematical precision we associate with neat computer printouts. Much of the discussion is overlaid and often confused by differing social, security, or other priorities, which impact the budget. And there are differences in economic analysis as well.

All of this has made it harder to reach a consensus, and to take action in an area where action is inherently difficult. That is one reason why I welcome the effort you have been making to clarify the issues. I believe it is realistic to suggest that out of discussions like this, a large measure of agreement is emerging about the nature of the problem, if not yet agreement about just how to go about dealing with it.

My contribution may fall more in the former category than the latter, which does raise issues outside the purview of my own responsibilities. But, on the assumption that the interaction of fiscal with monetary policies is of critical importance to economic developments, I will not apologize for reviewing some familiar ground.

We don't yet have the benefit of the Administration's budget plan or updated projections from the Congressional Budget Office. But the general magnitudes involved are familiar enough. The deficit for the current fiscal year -- and it's probably too late to do much about it, even if there were a consensus that action

were desirable -- is generally estimated at \$175 to \$200 billion. And, as I will amplify later, the outcome will remain in that range, or higher, as far ahead as one can see, given present programs and assuming healthy and prolonged economic growth. Indeed, the figures have been cited so often that any sense of alarm may be dissipated by the very familiarity with the numbers. The burden of my comments today is that the hazard is real; that the deficits around 20-25 percent of expenditures and 5 percent or more of the GNP are unacceptably large in a growing economy; and that absence of timely action to reduce those deficits as the economy grows raises a most serious question as to whether the economic expansion we want could, in fact, be sustained for long.

Obviously, we are negotiating a most difficult period in our nation's economic history. But I also believe we can lay -- we are in the process of laying -- the base for more vigorous and lasting growth. There are now signs that recessionary pressures in some key sectors have abated. Certainly, considerable progress has been made in reversing the inflationary trend of the previous decade. Thus, the stage is set for an economic recovery that can combine the increase in job opportunities and real income that we all desire with greater price stability and more stable, accommodating financial markets. The relevance of action on the deficit is that it is needed to help reconcile those objectives; without such a reconciliation, we risk losing them all.

As you know, consumer prices rose less than 5 percent last year, the slowest rate of increase in a decade and a remarkable improvement from other recent years. We need to recognize that part of the improvement reflected unusually favorable food and energy price developments, low commodity prices generally, and more intense price competition from abroad because of exchange rate considerations. We can't count on those factors continuing indefinitely. Moreover, we must also recognize that we are still far short of price stability; in fact, inflation is really only back to the pace of 1971, which was judged so intolerable at that time that wage and price controls were imposed.

Unlike 1971, however -- in fact unlike the entire 1970s -- trends of underlying costs and inflation expectations are now moving lower; and those trends should be sustainable as the economy recovers its upward momentum in 1983 and beyond. In that connection, the recent behavior of productivity is encouraging. After declining throughout much of the late 1970s and into the early 1980s, labor productivity turned up appreciably last year. The data are always hard to interpret in the midst of recession, but there is now quite a lot of evidence that potentially lasting improvements in efficiency by both workers and management are underway. Combined with continuing moderation in growth of nominal wage and salary payments, the result should bring long-lasting reductions in cost pressures and expansion of real incomes.

I am acutely aware that these gains against inflation have been achieved in a context of serious economic hardship. Millions of workers are unemployed, many businesses are hard-pressed to maintain profitability, and business bankruptcies are at a postwar high. In my view, those hardships could not have been escaped by simply letting inflation proceed and accelerate, with all the damage that would imply to the basic productive capability of the economy and the social fabric. But it certainly does emphasize the need to carry through -- not simply to start a recovery, but to put policies in place that can sustain an expansion of output and employment over the years ahead.

It is in that context -- the need to realize the longer-run promise in our current situation -- that our ability to bring the ballooning federal deficits under control is critical.

A few figures suggest the perspective. During the 1970s, the federal deficit averaged around 2 percent of GNP, rising to a peak of 4 percent in fiscal year 1976 in the middle of the deepest recession of the postwar period. We thought those figures were high, and in historical perspective they were. In contrast, the deficit in the current fiscal year could reach about 6 percent of GNP.

While hardly comforting, that figure is still not the crux of the problem. The current deficit reflects the effects of unsatisfactory economic performance and high unemployment. In that sense, well over half -- perhaps two-thirds -- reflects cyclical factors. The heart of the difficulty is that there is, as things stand, no reasonable prospect that we can grow out of the deficit. Even if the economy expands at or beyond most projections,

over the next few years and with satisfactory price performance, the deficit is not likely to fall below 4-5 percent of GNP over the rest of the decade, assuming no change in current policies. Even those estimates may be a bit low.

It has become fashionable (and useful) to talk in terms of "cyclical" and "structural" deficits. These often are not well-understood concepts, and it would be useful to review them briefly.

The cyclical portion reflects the effect of current business conditions on the deficit. In a recession, the deficit is temporarily enlarged as slack activity and high unemployment cut into revenues and raise outlays for certain programs, most notably -- but not exclusively -- unemployment benefits. When activity is depressed these cyclical deficits can help support spendable incomes and reduce the fluctuations in activity. Today, that explains a large portion of the deficit, and it can be reasonably agreed at least that portion is benign, supporting income during recession.

In contrast, calculation of the structural deficit attempts to abstract from the cyclical stage of the economy. It reflects the imbalance that would remain even if the economy were operating at a fairly high level.

The reason the total deficit will not recede significantly as business recovers, and could even grow larger, is that the structural portion threatens to grow at least as fast as recovery reduces the cyclical component.

It is tempting to suggest that the budget problem is a statistical artifact related to "pessimistic" economic forecasts and can be eliminated by stronger economic growth than

is expected by most forecasters. But that is wishful thinking; under any reasonable forecast for sustained growth and without further policy adjustment, the deficits will remain historically huge unless we make the unacceptable assumption that we will also revert to an historically high inflation rate. I would point out that deficits of the size projected would feed on themselves because, in those circumstances, interest payments on the debt will remain a rapidly growing budget category, even in an environment of reasonably declining interest rates.

Ironically, the budget difficulties over the medium term are compounded by our success in bringing down inflation. Although there is little doubt of the longer-run benefits to the economy (and eventually the budget) of lower inflation, the transition to lower inflation for a while widens the deficit. In terms of revenues, the adjustment to reduced inflation largely is contemporaneous, as receipts quickly reflect the slower expansion of nominal income. On the spending side, however, the response is considerably slower and possibly smaller.

Outlays in indexed programs -- which comprise about a third of the budget -- respond automatically to inflation, but with a lag. At the same time, a large share of the budget is set in nominal, not real, terms. In logic, appropriations should be cut to reflect a lower rate of price increase; in practice, that response to disinflation is likely to be imperfect. Specific action must be taken to pare outlays to reflect the lower prices, and inertia works against the process. One example of this problem

has recently received attention in the press: how to "spend" the dividend of lower inflation for defense programs.

In this connection, I would note that price performance last year was far better than expected by many forecasters. While that has had short-run budgetary consequences, we are still obviously some distance from price performance that could be called "reasonable stability." Realistically, it seems to me, we can and should look to further declines in the inflation rate, and take account of that in our budgetary planning.

As I suggested earlier, we can all try to refine estimates, looking at different growth and inflation rates, as well as more technical considerations. But what stands out in the present situation is that, whatever those particular assumptions, we now have a federal budget situation in which current spending plans for years ahead outrun the revenue base by a wide margin. The problem will not go away as the economy recovers from the recession.

Left unattended, that situation poses a strong potential for a clash between the need to finance the deficit and the rising financial requirements for housing and the business investment that is crucial to healthy and sustained recovery. In the end, all those needs have to be met out of saving, and all our experience suggests there isn't likely to be enough to go around.

Savings -- net of depreciation -- has typically run at 10 percent or less of the GNP. The prospective structural deficits later in the decade could well absorb as much as one-half of that amount. Gross savings -- that is, including capital consumption -- are roughly twice the net. But the prospective deficits would still preempt as much as a quarter of the total. Looked at either way, the diversion of savings would be without peacetime precedent for relatively prosperous years.

Of course, the government will be financed. It will be financed in the market, and the unavoidable implication is that interest rates will in real terms be bid higher than otherwise. The higher interest rates will dampen private investment and housing. They may also attract funds from abroad, supplementing our domestic savings. But a net transfer of savings from abroad implies a current account deficit -- in other words, relatively weak exports and high imports, hardly a happy prospect. The long-run implication is both a weak investment and a weak balance of payments structure, with a lower level of output over time.

That, essentially, is the "text book" analysis. In the real world of today, the adverse consequences are likely to be exacerbated.

After years of inflation, sharp fluctuations in interest rates, and unsatisfactory economic performance, an atmosphere of exceptional caution and uncertainty about future planning by business is understandable. I don't think there is much doubt

that the prospect of huge budget deficits contributes to that mood in a way that cannot be precisely measured -- lingering concerns about a sharp rebound in interest rates from already relatively high levels, continuing strong pressures on monetary policy, or a reversion to inflationary policies "forced" by the deficits.

The point is reinforced by the sense of uncertainty in financial markets and institutional strains domestically and internationally, strains that are aggravated to the extent that the basic level of interest rates is higher than otherwise necessary. We fortunately have a strong and effective governmental apparatus undergirding the stability of the financial structure. But we work at cross purposes to encouraging recovery to the extent that anticipation of future excessive budgetary deficits add to market pressures.

In that respect, let me emphasize again that my concern is much more about the growing structural deficit than the present cyclical deficit.

In the fiscal policy environment we became accustomed to in the postwar era, the expansion of federal budget deficits in periods of economic slack certainly did not prevent interest rate declines in recession, and interest rates have, of course, declined in 1982 despite a larger deficit. In circumstances like those, private credit demands drop, helping to offset the impact

of the deficit. Moreover, in the past the reasonable expectation that large deficits would recede as business activity turned up sustained confidence about the stabilizing role of the federal budget.

The current atmosphere is quite different in that respect. To be sure, it can be said that most of the recent and current budget deficits are recession-induced, replacing rather than competing with private credit demands. But we cannot now look forward to a return to balance or low deficits as the economy expands.

That is one reason, despite the large recent declines, interest rates remain high by historical standards. Moreover, concern is expressed that interest rates have neared their cyclical lows and could rise again as economic activity recovers, even though they remain well above current inflation rates.

The question naturally arises, if all that is true, whether monetary policy shouldn't do something about it in the interests of speeding lower interest rates and recovery. In approaching that question, I must first emphasize that monetary policy cannot itself create real savings and correct a structural deficit. The basic savings-investment balance -- with all its implications for future real interest rates -- is simply beyond our influence.

We can, indeed, influence the growth of the money supply and other liquid assets and the degree of current pressure on bank reserve positions. In fact, growth in the monetary

aggregates has been relatively high in recent months, and exceeded the targets set early in 1982. Reserve pressures have been minimal. Under all the circumstances, that result has seemed appropriate, given the evident desire to hold more liquidity, and fully consistent with the needs of the economy and progress against inflation.

But there are limits to the process of credit and money creation. Beyond a certain point, the result would be to create further doubt about the prospects for further disinflation and lower interest rates, aggravating the uncertainties in those respects related to the budget deficit. In the end, excessive monetary growth would put us back in the same unsatisfactory situation of more deeply ingrained inflation expectations and greater skepticism about the ability of our nation to manage its economic affairs. The effects on interest rates -- particularly long-term interest rates -- and on prospects for sustained recovery would thus be perverse.

There was a time when the American public felt confident about the ability of government to maintain stability and improve its economic situation. The events of the past decade and more undermined that sense of conviction, and we must restore it. In some ways -- notably in the progress against inflation -- we are making progress. But fears that excessive budget deficits will undermine financial discipline work in the opposite direction, and those fears would only be compounded by excessive monetary expansion.

Let me put the point another way. We are exposed to fears of "out-of-control" structural deficits, and the result is upward pressure on interest rates, particularly at the longer end of the maturity spectrum, for reasons beyond measurable economic effects. The budget is a plan: as such, it is a powerful symbol of the government's resolve to follow a disciplined non-inflationary course. To the extent the budget deficit appears to be intractable, the burden placed on monetary policy to demonstrate the government's resolve to restore stability is increased, and our flexibility in responding to current developments is reduced, not enhanced. The converse is equally true -- meaningful action to demonstrate the government's economic discipline on the fiscal side would reduce concern about future inflation and future interest rates. In the process, it would reinforce confidence that monetary policy over the years ahead can do its job in maintaining a course consistent with price stability without intolerable market pressures.

The focus on monetary policy -- together with the understandable urge to seek a relatively simple, comprehensible and desirable measure for "policy" in the interest of maintaining confidence -- has spawned a number of proposals for a fixed rule, whether a pre-set monetary target for years ahead, a fixed price for gold or other commodities, or keeping interest rates, real or nominal, short or long, within some band. I can understand and sympathize with the desire. But I am skeptical, to

say the least, that in so complex and changing an economy as ours, the policy problem or the policy objective can be reduced to so simple and unvarying a measure. The recent distortions in the monetary aggregates relating to purely institutional change -- the introduction of new high-interest deposit instruments on the border of "money" and "savings" -- reflect one kind of difficulty that arises from time to time. More significant over time may be shifts in established relationships in trends in the "target" and the real world of economic activity and inflation. We can all appreciate the desirability of laying out policy intentions as clearly and simply as possible. But I doubt that we can, in effect, ever put policy on "automatic pilot," and that any simple rule for monetary policy can effectively substitute for a coherent overall policy approach, of which the budget is inevitably an important part.

I also don't want to suggest there is a simple "tradeoff," as sometimes suggested, between future budget policy and current monetary policy. Reducing the threat of those large structural deficits stretching out to the end of the decade, in and of itself, should have favorable effects on current interest rates and in damping concerns about future increases. In this setting, the old maxim about virtue providing its own reward should be measurable in a tangible way. And there can be broader benefits. The lower the structural deficit the greater the confidence, not just of the financial markets but of the community at large -- labor and management, storekeeper and

shopper, at home and abroad -- in the government's will to follow a disciplined course. This should reinforce the disinflation process, even as recovery proceeds. It will support moderation in wage bargaining, caution in pricing policies, confidence in financial markets -- and, of course, lower real interest rates.

None of that would justify monetary policy moving in a contrary direction -- abandoning our continuing and necessary concern with restoring reasonable price stability. That point remains central. At the same time, a better fiscal outlook -- with all it implies -- would certainly provide a better environment for the conduct of monetary policy, relieving concern about the longer-term implications of every twist and turn in the monetary aggregates or short-term policy actions. As things stand, fear of growing deficits clouds the future and contributes to market pressures and inflationary uncertainties, adding to the burdens on monetary policy.

I am conscious that I have taken too long to identify a problem with which you are broadly familiar. The need is to resolve the problem. We have time, in the sense that we are talking about changes that should only begin to take effect in 1984, with full impact in 1985, in 1986, and the years beyond; an abrupt change in 1983 is neither feasible, nor in the midst of recession and with the structural portion of the deficit still limited, desirable. But it is also true that if those future deficits are to be controlled, the process must start now and

with energy and force. Basic budget trends take time to change, and the knowledge that they will be changed is what will affect markets now.

The amounts involved are large, but certainly not beyond our capacity. The necessary changes can be phased in over a two or three year period. Our capacity to save and to finance is large enough so that some residual deficit can be managed.

It is obviously beyond my competence, or the province of the Federal Reserve, to deal with all the particular priorities that must be balanced -- national and social security, entitlements and taxes. The sheer arithmetic of the Budget does suggest that some changes will be necessary in all the major budget components, and we are all aware that initiatives have already been proposed in a number of areas.

I do not for a moment underestimate the task before the Administration and the Congress in reconciling the competing claims, and achieving the necessary legislation. But I also believe the problem is now well recognized, and that the bleak budgetary picture I have described earlier will not, in fact, be permitted to materialize. We have come a long way toward laying the groundwork for lasting expansion, and we can and will deal with this challenge.

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