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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Appropriations

United States Senate

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I appreciate this opportunity to discuss with you important economic issues that are of concern to all of us. Obviously, interrelationships among monetary, fiscal, and other policies have important bearing on our national economic performance and, especially, on the performance of our credit markets. The Federal Reserve has responsibilities only for monetary policy. This Committee has a leading role in determining federal spending and, through that avenue, in determining federal demands on credit markets. Although this Committee must deal with a great many specific program details -- all of them beyond the purview of the Federal Reserve -- the sum of your actions and their longer-term implications are directly relevant to monetary conditions and economic prospects.

Clearly, the economy is going through troubled times. Unemployment is painfully high, particularly in older industrial regions. Interest rates are imposing severe strains on housing, small business, and agriculture, and on thrifts and certain other financial institutions. These problems are in major part a legacy of high inflation and lagging productivity growth over a number of years.

I believe that there are strong reasons to expect a cyclical upturn later this year. Our monetary policy targets will accommodate such an upturn. And the deficit for the current year, with its large cyclical component, should be manageable; to a considerable extent, by supporting income flows and spending during the recession, it can help stabilize the economy and induce recovery.

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For future years, the situation is quite different. We face the bleak prospect, as things now stand, and without strong action to contain spending and to increase revenues, that budgetary deficits will rise very substantially, even assuming satisfactory economic growth. That prospect threatens the recovery in business investment and housing we need by potentially preempting a sizable fraction of our savings potential; moreover, the future implications for congested credit markets feed back on present interest rates, as lenders and borrowers "discount" what might happen in the years ahead. While it might be argued that larger growth in the money supply, now or prospectively, could relieve the pressure, one result would be to renew fears of inflation, just as marked progress toward greater price stability is apparent. An inflationary increase in the money supply cannot substitute for real savings, and, in time, would result in higher rather than lower interest rates.

Clearly, the potential problem before us lies squarely at the intersection of monetary and fiscal policy, and of our respective responsibilities. For that reason, I should like, first, to review the recent and prospective course of monetary policy and then to discuss its relationship to the fiscal problem.

Monetary policy has, of course, been directed toward restraining growth in money and credit with the important objective of reducing inflationary pressures and placing the economy on a course toward price stability. The hard fact is that uprooting a deeply embedded inflationary process is difficult;

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it is made even more difficult to the extent the effort is concentrated on one policy instrument. The fact that interest rates have remained painfully high in the midst of recession, restraining activity in credit-dependent sectors of the economy is one reflection of the difficulty. But the problem extends back over a number of years. As you know, the current recession has been superimposed on a pattern of stagnation extending over a considerable period.

In broad terms, I don't think there is any great mystery as to why the economy has behaved this way. Beginning in the mid-1960s, inflation increasingly became a way of life, and in the process distorted economic incentives, sapped our productive energies, and caused arbitrary and capricious transfers of income and wealth. For a time, as inflation gained momentum, real interest rates were low or negative. But after inflation took hold, and became embedded in behavior and expectations, anticipations by borrowers and lenders alike tended to propel interest rates higher. And, as monetary policy moved to deal more forcefully with the inflation -- particularly in a context of fiscal imbalance -- the strain on financial markets became more acute.

The alternative course of simply accommodating inflation by providing it monetary sustenance would, however, offer no lasting relief. By feeding expectations of inflation and reinforcing the reluctance of lenders to commit funds for any but the briefest periods of time, the high level of interest rates (particularly long-term rates) would only become further embedded

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in the economy. The hard fact is that loss of our most important financial yardstick -- a stable dollar -- bred high and volatile interest rates. Restoration and maintenance of lower interest rates is ultimately dependent on greater confidence that stability can and will be restored.

Developments during 1981 seem to me broadly consistent with that effort. While particular measures of money and credit diverged, responding in large part to legislative, regulatory, and institutional change affecting the way businesses and individuals chose to hold their financial assets, the general direction was consistent with the effort to curb the monetary sources of inflation. Specifically, M1B growth (adjusted for the estimated shift of funds into NOW accounts) decelerated further last year, averaging a little more than 1 percent lower than the previous year -- the third consecutive year of such deceleration. Growth of the broader aggregate M2 averaged a bit higher than in 1980, but that rise, at the margin, reflected extraordinary growth in money market funds and regulatory and legislative changes affecting the attractiveness of time deposits, which pulled into M2 some funds that otherwise would have been placed elsewhere.

Despite the slow growth of the narrowly defined money supply, short-term interest rates fell substantially from mid-year peaks, particularly sharply after the recession took hold. As you know, however, short-term rates retraced part of that decline late in the year and early in 1982. The money supply rose particularly sharply in the early weeks of 1982, and as a result, bank reserve positions came under renewed pressure.

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A spurt in money growth is unusual in a context of weak production and income, and it appeared at least partly related to uncertainties on the part of individuals, leading them to shift a portion of their financial assets into the most liquid form. More recently, the excessive growth has appeared to be subsiding, and interest rates have turned somewhat lower. But a characteristic of the past year has been the persistently high level of intermediate- and long-term interest rates, an area of the market most heavily affected by expectations.

Those interest rates have remained high despite visible progress -- and potentially lasting progress -- on the inflation front. To be sure, some of the progress against inflation reflects the more immediate, and potentially reversible, effects of recession-weakened markets, current surpluses in petroleum and grain production, and reduced commodity speculation and pressures generally for inventory liquidation due to extraordinarily high interest rates. However, we can now also see encouraging signs of more lasting progress. Attitudes of business and labor toward pricing and wage bargaining, and toward work rules that hamper productivity, seem to be changing. Not surprisingly, that is most clearly apparent in industries where costs and wages have been most clearly out of line and where international competitive pressures or those resulting from regulatory change are particularly intense. But -- so long as monetary and fiscal policies are appropriate -- I believe these changes will be reflected in a spreading pattern of cost and

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price restraint. Individually, workers and businessmen are naturally reluctant to maintain such restraint, partly for fear their concessions will not be matched by those of others. But collectively, such restraint, combined with higher productivity, will be amply repaid in the form of higher real wages and better prospects for job security. This is the foundation on which we can expect to build a sustainable recovery.

If these brighter prospects are to be achieved, however, we cannot afford -- just as the disinflationary process is beginning to take hold -- to abandon our monetary vigilance. Past failures to "carry through" have left a legacy of skepticism and uncertainty among workers and businessmen, among consumers, and, not least, among participants in financial markets where lenders demand "inflation" and "uncertainty" premiums when committing their funds. That is one important factor holding up longer-term interest rates. Credibility in dealing with inflation will have to be earned by performance and persistence over time. And, I believe, it is broadly and rightly recognized that appropriate restraint on the expansion of money and credit will continue to be fundamental to restoring price stability.

Our intentions with respect to money and credit growth in 1982, reported to Congress three weeks ago, seem to me consistent with that need. The monetary targets are, we believe, consistent with recovery in real business activity over the second half of the year; in fact, the target range for M1 is

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consistent with somewhat larger growth in that aggregate than actual growth of the adjusted measure during 1981. At the same time, the targets do assume, and are designed to encourage, further progress toward price stability. In that sense, they are a "tight fit."

The performance of the credit markets in 1982 and beyond, in a framework of disciplined monetary policy, will be heavily influenced by supply and demand forces other than the course of inflation and inflationary expectations. Key among these is the size of the federal deficit.

Government borrowing and private borrowing compete for a limited supply of available savings and credit. That competition is usually ameliorated in the midst of recession because private credit demands are reduced. But a more prosperous economy also implies much stronger needs for mortgage and business credit; indeed, sustained recovery of the private economy, and the investment we need to support productivity, is dependent on more favorable financial market conditions. It is precisely those more favorable market conditions that are threatened by prospects for sharply rising deficits in fiscal 1983 and the years beyond. Members of this Committee are acutely aware that all of the familiar projections, by the Administration, the Congressional Budget Office and private forecasters, point to historically huge deficits, assuming the Administration's defense plans are broadly carried out and no new steps are taken to curtail nondefense

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spending or raise revenues. We can debate whether the estimates of the Administration or the Congressional Budget Office are more accurate. But the point is that there is no disagreement that deficits would rise to $150 billion and beyond, in a context of a steadily expanding economy, under either set of assumptions, and deficits of those magnitudes cannot be acceptable -- not if we, in fact, want to see the rise in investment and housing we want.

Projecting the federal budgetary position for several years ahead necessarily involves a range of uncertainty about spending and tax programs, the level of interest rates, and overall GNP. Moreover, there is a range of possible outcomes with respect to our savings potential and sources of funds in the credit markets, even with given assumptions regarding the GNP. Nevertheless, some general implications of the budgetary outlook as it stands are clear enough.

In the absence of action, the projected deficits would be outside the range of peacetime experience for good business years, whether measured in absolute terms or in relation to the potential GNP and savings.

In recognition of those concerns, the Administration has proposed large cuts in spending and some measures to increase revenues. Such action would go a long way toward bringing the deficits down, cutting them by one-half or so in fiscal 1984 according to Administration estimates. But even with such forceful action, the size of the projected deficits would remain large, relative to savings and the GNP, for a relatively prosperous business year. While a few years in the 1970s appear

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roughly comparable, there would appear to be little or no "safety margin" for meeting expanded investment requirements. Should the deficit trends be more adverse, as the Congressional Budget Office suggests, the potential for "crowding out" private investment would be greater.

A substantial increase in savings could help protect against the implied squeeze on financial markets. Indeed, business saving is likely to be enhanced substantially by the provisions of last year's tax bill and personal saving should also be increased as inflation declines and in response to other incentives. But we also need to remember that the larger savings potential should not be dissipated in financing government purchases or transfer payments when our investment needs are so urgent.

The hard fact is we cannot escape a choice -- whether we want to encourage more favorable financing conditions for the private sector or whether we are willing to risk seeing our savings and financial resources diverted in large measure to financing a federal deficit.

While it is the deficits for fiscal 1983, 1984, and beyond that loom so large, action is needed now for several reasons. First, as you know, the budgetary momentum cannot be curbed without planning ahead. Steps to achieve large reductions in spending or higher receipts in fiscal 1983 -- only six months off -- need to be put in place soon, and measures of spending restraint should be undertaken during the current Congressional session to be fully effective in fiscal 1984.

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Second, deficits of the projected magnitude are in some degree self-reinforcing. Prolongation of high deficits and high interest rates feeds back into future debt service and budget expenditures.

Finally, and most important, uncertainties about future credit market pressures cloud the planning of investors today. Strong actions taken now to assure that deficits can and will be reduced as the economy recovers can go far toward galvanizing investor attitudes in a favorable direction. Paradoxical as it may seem in the light of some past economic analysis -- analysis developed when inflation and high interest rates were not a pre-occupation -- prospects for recovery can be speeded by decisive action by this Committee and your Congressional colleagues to curb future deficits, for the result would be to relieve apprehension in the market that contributes to today's high rates.

As I noted earlier, if enacted, the proposals by the Administration for deficit-reducing measures totaling over $55 billion in fiscal 1983 and approaching $85 billion in 1984 would go a long way toward ameliorating the potential problem. They represent a major challenge to the Congress, but I would urge upon you the desirability of going even further to reduce demonstrably the pattern of deficits as the economy recovers. The appropriate target, it seems to me, would be to restore the prospect of budgetary balance as a high level of economic activity is restored.

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On purely economic grounds, I believe that lower taxes will enable the economy to perform more effectively and that higher marginal tax rates distort incentives and impede economic efficiency. But you must weigh many considerations, and I recognize the choices before you are extremely difficult and involve detailed considerations of social objectives and program objectives beyond the purview of the Federal Reserve. To the extent that the job cannot be accomplished by further steps to reduce spending growth, I see no alternative but action to bring the trend of revenues into better alignment with spending prospects.

In concluding, I would emphasize that the main directions of economic policy laid out last year seem to me broadly appropriate to the challenge before us. We are making progress against inflation, and sustaining that progress is fundamental to a brighter future. Tax and other policies developed last year should contribute to a more productive, competitive economy. Some steps have been taken to slow the strong upward momentum in Government spending.

At the same time, the agenda for action is clear. The Federal Reserve will maintain the needed degree of monetary discipline. We need decisive action to curtail budget deficits.

As we approach that agenda, I can only be encouraged by the degree of understanding of the nature and the urgency of the problems before us. I believe there is a sense that, difficult as it is, the Congress and the Administration have an opportunity in coming weeks to seize the initiative with a

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strong budgetary program. We in the Federal Reserve mean to do our part in fostering confidence in financial markets. Together, we can move from challenge to conviction that the base has been laid for national recovery.

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