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Statement by

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before the

Committee on the Budget

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I appreciate the opportunity to appear before this Committee today to discuss with you directly -- as I have with other Committees -- the current economic and budgetary situation and the Federal Reserve's goals for monetary policy. A few weeks ago I presented to the Senate Banking Committee the specific numerical targets for the growth of money and credit in 1983 set by the Federal Open Market Committee (FOMC) and I believe you have the Monetary Policy Report to Congress before you. Therefore, I would like to focus this morning on the broad issues confronting monetary policy and their relationship to other aspects of domestic and international economic policy.

Current Economic Conditions

In order to put these issues in context, I should begin with a few comments on where the economy stands today. After a long period of recession, activity is showing signs of increasing strength in several sectors. Meanwhile, we have made impressive progress against inflation over the past year, and the underlying trends, combined with the weakness of oil prices, suggest that progress can be extended. Altogether, much of the stage has been set for a sound recovery in business activity that will bring with it the increases in job opportunities and real income that we all desire. But the setting is not complete; more needs to be done to provide reasonable assurance that the present signs of recovery in fact evolve into a long-lasting non-inflationary expansion.

A key element in the improved outlook is the change in financial market conditions. Short-term interest rates are now as much as 10 percentage points below their cyclical peaks, while long-term rates are down about 4 to 5 percentage points. Bank loan rates -- particularly rates for consumer credit, which are typically less flexible -- have tended to lag behind market rates, but they have come down further in recent weeks. Reflecting these developments, activity has been improving, especially in the credit-sensitive sectors of the economy.

The most notable turnaround has been in the housing market. Production and sales of new single-family homes have now risen substantially over the depressed levels of late 1981 and the first half of 1982. With personal debts relative to income lower than in several years and with liquid assets rising, activity in consumer markets also has shown some signs of improvement. Auto sales, responding in part to the lower interest rates offered under special programs and greater pricing restraint, are running above the recession lows, although still far below pre-recession norms. Moreover, orders and consumer purchases of other "big-ticket" items also appear to be improving, partly in association with the upturn in home sales.

As is usually the case, the inventory cycle has played a large role in the recession, and will be a determinant of the speed of the recovery in its early stages. Businesses made vigorous efforts to control the accumulation of unwanted stocks early in the recession and again in the final months of 1982 when the previously anticipated upturn in sales failed to develop. With further liquidation in January, inventories generally are now back to the levels of early 1981. Consequently, as final sales strengthen more broadly, increases in production could be more than proportionate. Nonetheless, tight inventory management -- against a background of declining inflation, ample production capacity, and relatively high interest rates - is likely to remain a factor making this recovery more moderately paced than most past upturns.

For the time being, with excess capacity substantial and profits depressed, business investment in new plant and equipment is also likely to lag. Some delay in the recovery of capital spending is not out of line with previous cyclical experience, as many firms initially intensify the use of existing capital rather than invest in new plant and equipment. Nonetheless, there are some encouraging signs in this sector. In particular, new orders and appropriations for capital goods have firmed in recent months. Moreover, lower costs for long-term borrowing and the surge in stock prices have encouraged firms to begin re-structuring their balance sheets -- thereby putting the business sector on a sounder footing for expansion.

The U.S. economy has become increasingly integrated into the world economy over the years. In contrast to most earlier recessions, exports dropped sharply in 1982, reflecting both the recessionary tendencies in the rest of the world and substantial appreciation of the dollar in 1981 and much of 1982. The sluggishness of business activity abroad is an important reason that recovery here is likely to be less rapid than after most previous recessions.

The Outlook for Inflation and Interest Rates

Ultimately much more important than the speed of the "start up" is the staying power of the recovery. A long sustained expansion in the economy will depend in major part on our success in maintaining the progress against inflation in the years ahead, not least because of its implications for interest rates.

Interest rates and inflation rates frequently do not bear a close relationship to each other for short time periods, and those periods can sometimes extend over several years. Over longer periods, however, there are strong analytic reasons to expect a closer relationship because borrowers and lenders alike are interested in real returns -- that is, in assessing the costs or returns on investments after allowance for changing prices. What counts, in this respect, is expected prices, which we cannot measure directly. If substantial fears exist that the progress against inflation may not be maintained -- and those concerns do remain -- interest rates, and particularly long-term rates, will remain higher than otherwise necessary. That situation is greatly aggravated, as I will discuss in a few minutes, by the prospect of outsized federal budget deficits in future years. Since high interest rates can be an obstacle to the financial health of households and firms and to well-balanced recovery generally, we must deal with these doubts and concerns.

Looking back, the gains in the fight against inflation are striking. All broad measures of prices rose less than 5 percent last year, the slowest rate of increase in a decade. Part of the rapid improvement reflected unusually favorable food and energy price developments, abnormally low commodity prices generally, the effects of the sharp appreciation of the dollar, and more broadly, the cyclical weakness of the economy.

The need is to "build in" a trend toward more stable underlying costs even as the economy recovers its upward momentum. One encouraging element is the recent and prospective behavior of productivity. After languishing in the late 1970s and early 1980s, labor productivity turned up last year, somewhat unusual in the midst of recession. Beyond those statistics, which at this point can only be suggestive of a changing trend, there is increasing evidence of efforts by both workers and management -- under the pressures of competition and recession -- to increase efficiency. The fruits of those efforts should become more apparent as recovery takes hold.

Increases in worker compensation slowed to about 6½ percent last year, and the pace currently seems to be slowing further. Given the increases in productivity and the other factors that contributed to lower prices last year, that slowing of nominal wage increases has been fully consistent with a significant increase in real wages for those working; in fact, the real income of the average worker rose in 1982 for the first time in four years.

With real wages rising, one source of pressure for aggressive wage bargaining should subside. For the time being, the high levels of unemployment and intense competitive pressures point in the same direction. Some industries, characterized by major structural as well as cyclical problems and wage levels far above national averages, have negotiated concessions from previous compensation patterns, potentially improving their competitive position and outlook for reemployment of those laid off.

Plainly, success in dealing with inflation cannot be based on an economy that stays in recession, with unacceptable levels of unemployment. But neither can we anticipate continuing improvement in the economy and lower interest rates if fears of re-acceleration in inflation are stimulated and justified by events. Continued moderation in wage settlements and pricing policies as the economy expands will be a key signal of success in the effort to maintain the disinflationary process.

The favorable near-term outlook in that respect is reinforced by the current softness in the price of oil. Petroleum prices are important because they, directly or indirectly, affect the cost of so much that we buy -- finished petroleum products account for 8-9 percent of the GNP. Furthermore, a decline in the price of those products, which led the inflationary process in the 1970s, is highly visible to every citizen, and can help symbolize the fact that the climate of inflation has in fact changed -- that prices are a two-way street.

But a favorable break in oil markets must not distract us from the larger truth. Continued moderation in pricing and wages and attention to cost-cutting and productivity is dependent on a sense of conviction that financial discipline will be maintained, and that aggressive pricing or neglect of costs will not "pay off" -- that it will instead threaten markets, profits and jobs. In other words, government policy will need to remain demonstrably alert and forceful in dealing with inflationary threats as the economy expands. With that conviction, interest rates can be both lower and less volatile, helping to support the expansion in investment and sustained growth we need.

Monetary Policy in 1983

As you well know, the long years of accelerating inflation after the mid-1960s undermined any sense of confidence that stability would be restored. Nor did the inflationary process, in the end, "buy" us more employment and production; instead we harvested the bitter fruits of rising unemployment, instability in financial markets and the economy, and historically high interest rates. Now, after attaching high priority to the effort over several years, we have a clear opportunity to restore a more stable environment and a climate for growth - indeed, we have come a long way in that direction. But, inevitably, a year or two of progress against inflation has not erased the skepticism rooted in the events of a decade and more; the battle is not over. And it is in that context that we have to shape our monetary and fiscal policies.

In concept, the role for monetary policy is simple: build on the progress against inflation by avoiding excessive growth in money and credit, while providing enough liquidity to meet the needs of recovery. In practice, the path is strewn with obstacles; indeed, the possibility of meeting both criteria simultaneously will be a function of policies and circumstances beyond the scope of any monetary policy, however wisely conducted.

In the best of circumstances, the line between too much money and too little cannot be plotted with mathematical precision. Rapid institutional change, reflected in the development of new deposit accounts and the payment of market rates on existing accounts, huge Federal financing needs, and the close linkage of financial markets internationally, all complicate the job further. Elements of judgment are inevitably involved. But in making those judgments, we are guided by one fundamental: renewed inflation -- or policies that seem likely to lead to that result -- is neither a satisfactory nor a practical option. The sensitivity of the public and the markets to signs of resurgent inflation would be all too likely to produce precisely the reactions in financial markets -- and in wage bargaining and pricing policies --

that would soon weaken or abort recovery. The result would be a re-play of the past decade or worse.

The prospect of Federal deficits that, as things now stand, will preempt a large portion of available credit and savings as the recovery proceeds threatens a "no win" situation. There is no monetary policy that can successfully resolve the economic and financial tensions that would arise from the clash of demands in the money markets from excessive deficits in a growing economy - the kind of economy that would generate growing credit demands for investment, for housing, and for other purposes. Moreover, the present budgetary outlook -- until corrected -- can only maintain skepticism about our success in dealing with inflation, narrowing the flexibility for monetary policy now.

The specifics of Federal Reserve policy with respect to the various monetary and credit aggregates are contained in the material that has been made available to you with this statement. I would only note now that the relationships between money and economic activity did not follow "normal" cyclical and trend patterns last year, partly because of the introduction of new types of deposit accounts but also because of broader economic reasons. Demands for money and liquidity appeared to be enlarged by the uncertainty of individuals and businesses about the economy and financial developments. There is also the clear possibility that the combination of declining inflation, lower market interest rates, and the increasingly common practice of paying interest on transactions accounts may have a lasting impact on trends in "velocity" -- perhaps working to lower the postwar trend increase -- and therefore on the appropriate growth of money over time.

Looking through all the complications and taking account of institutional distortions, our targets for money and credit growth in 1983 are similar to those in 1982. Because actual growth last year generally exceeded the target ranges, the effective growth this year should be less than in 1982. Based on present evidence and allowing to some degree for usual cyclical patterns, that amount of liquidity should be fully consistent with anticipated growth in the economy. In a context of declining inflation, the monetary targets themselves should be consistent with somewhat greater growth than the Administration projected in February (and probably with the somewhat higher projections of the Congressional Budget Office as well) and with further reductions in interest rates. But I must immediately add that other factors, importantly including the present and prospective budget deficits, impinge strongly on interest rate levels.

The variety of monetary indicators we use and the rapidity of institutional change are potentially confusing. In the circumstances, there is an understandable yearning by some to encompass all policy considerations in a simple, relatively rigid rule. But I know of no such rule reliably suited to our present circumstances. Elements of judgment seem to me inevitably necessary in interpreting the data, and the targets will need to be judged and reviewed at suitable intervals in the light of developments with respect to economic activity and prices and conditions in the domestic and international financial markets. At the same time, the targets do provide a needed discipline, and we mean to be within them over relevant spans of time. They will be changed only if evidence for such change is strongly persuasive.

As I have already suggested, we do take as a point of departure in our judgments the critical importance of maintaining the momentum against inflation. In fact, most members of the Federal Open Market Committee believe that, measured by the broader price indices, the inflation outcome in 1983 should be better than projected by either the Administration or the Congressional Budget Office. The recent developments with respect to oil prices are consistent with that outlook. Within a given supply of money and credit, such an inflation outlook implies lower interest rates than otherwise and more room for real growth.

The more difficult question may be whether the momentum toward price stability can be maintained in later years. As you know, both the Administration and the Congressional Budget Office project that inflation will "settle down at a rate within one percent of recent levels. While a vast improvement from the 1970s, that, to me, would be an unsatisfactory result. Inflation increasing at four to five percent a year is large enough to have distorting influences on financial markets, the budget, and the economy, and it would tend to keep alive fears of a resurgence as unemployment and excess capacity decline. We can do, and have done, better, and a clearer path toward price stability would, in my judgment, provide a sounder footing for financial stability and sustained expansion.

Current interest rates, particularly long-term rates, still appear to carry a large premium against the risks of higher inflation. Whatever you or I -- or the Administration or the

Congressional Budget Office -- may judge a realistic forecast, the false starts of the past in dealing with inflation have understandably left a residue of skepticism about the progress that has been made. Like it or not, the market's assessment of the future will be judged by performance now, and a strong sense of conviction that inflation will stay down will emerge only over time and with consistent effort to keep non-inflationary policies in place.

That is one reason why a number of public policies, apart from general monetary and fiscal policies, will be important beyond their more specific effects. For instance, a retreat to protectionism is both directly inflationary and indirectly a signal that moderation in pricing and wage behavior and productivity is not essential to maintain competitiveness. Emphasis on indexing betrays a lack of conviction in the effort to deal with inflation and offers an illusion of escape from its consequences. At a time when the budgetary deficits ahead already threaten to clog the money markets, building in still more spending programs -- certainly those with an added "spend out" into 1984 or beyond -- raises more questions about whether offsetting cuts can be made, and the benefits to one group can potentially be swamped by adverse effects elsewhere.

The Federal Budget and Monetary Policy

In the last fiscal year, the Federal deficit was a record $111 billion. The President's new budget projects a deficit in the current fiscal year nearly double last year's figure -- or about 6½ percent of the GNP. Further increases are projected into the foreseeable future in the absence of determined action to alter that outlook.

The members of this Committee, of course, are well aware of the magnitude of these projected deficits. In fact, numbers in the $200 billion plus range have become so familiar in recent weeks -- while interest rates have declined and the economy has shown signs of recovery -- that a temptation may arise to "wait and see," to step back for now from hard choices of where to cut or where to tax, and to look to monetary policy to solve the interest rate problem. But a passive approach just won't work.

In the midst of recession, we can manage a big deficit, even though it does keep interest rates higher than they would otherwise be. But over time, we can't expect "real" interest rates to revert to a low range historically, house our citizens the way they wish, invest what we need to support growth and productivity, and avoid drawing on the savings of other countries (at the expense of an abnormally strong dollar and a huge trade deficit) if Treasury financing absorbs half to three-quarters of the net domestic savings we are capable of generating in a more prosperous economy.

To put the point in its starkest form if no action is taken, deficits in the general range projected by the Administration and the Congressional Budget Office -- which broadly encompass those of other informed analysts, including those in the Federal

Reserve -- do not seem to me compatible with the assumption of a smoothly growing economy upon which the projections are based. No conceivable manipulation of monetary policy provides an escape; to the contrary, the implication is that monetary policy would need to carry a still heavier burden to demonstrate the government's resolve to follow a non-inflationary course.

The converse is equally true: meaningful action to demonstrate the government's economic discipline on the fiscal side would reinforce confidence that monetary policy over the years ahead can do its job in maintaining an appropriate degree of restraint on the growth of money and credit without intolerable pressures on the private sector. Reducing the threat of rising structural deficits stretching out to the end of the decade, by damping concerns about future interest rate increases, should in and of itself have favorable effects on current interest rates. In that real sense, setting a firm course toward future budgetary restraint should have immediate benefits, as well as safeguarding prospects for future investment.

I am not suggesting there is a simple tradeoff between growth in the money supply and budget deficits. If monetary policy were to abandon its continuing and necessary concern with restoring reasonable price stability, the benefits of budget restraint in encouraging confidence would be lost. What can be said is that a better fiscal outlook, with all it implies about less pressure to monetize the Federal debt and reduced concern about strong pressures on interest rates as the recovery is extended, would provide an environment in which monetary policy could better reconcile the goals of economic growth and financial stability.

As you know better than I, basic budget trends take time to change. The size of the needed reduction in the deficit increases progressively over a number of years, but the effort must start now, and with energy and force. The amounts involved are large, but certainly not beyond our control.

It is obviously beyond my competence, or the province of the Federal Reserve, to deal with all the particular priorities that must be balanced. The Administration has set forth its program in that respect. The general order of magnitude of the cuts in the structural deficit proposed by the Administration -- running to $125 billion and more for fiscal 1986 and beyond -- seems to me appropriate at this time. However, more of the actions should, in my judgment, be brought forward into fiscal 1984 and 1985, with the objective of, at the minimum, keeping the "structural" deficit well below $100 billion. I recognize estimates of deficits a number of years ahead, "structural" or otherwise, are subject to considerable margin of error, and those projected by the Administration are considerably larger than those of the Congressional Budget Office. But the direction and general magnitude of what is necessary seems clear enough; there is, as a practical matter, no danger of "overshooting" the mark. And, finer adjustments can be made, year by year, as more evidence accumulates.

The possibility of a large reduction in oil prices could offer new options in dealing with the budget. As I noted earlier, the prospect for declining oil prices helps to reinforce the outlook for further progress against inflation in the near term. It would also act, analogously with a tax cut, to increase domestic purchasing power and involve a direct loss of windfall profits tax revenues, further complicating the structural deficit. In the circumstances -- and taking account of the effects on domestic energy prices and conservation -- a deep decline in oil prices would suggest early reexamination of the case for energy taxes. The case would be reinforced to the extent a sharp oil price cut now, and relaxation of the conservation and exploration effort, implies the possibility of a strong rebound in oil prices in the future. One possibility would be to bring forward the kind of oil tax proposed by the Administration on a standby basis in fiscal 1986.

International Finance and the IMF

There is one other specific matter that I would like to touch upon that has virtually no implications for the deficit but great potential significance for our economic health. That item is the proposed increase in the resources of the International Monetary Fund.

Our economic recovery is complicated by the fact that the world generally has been mired in recession. One reflection of that has been to aggravate the strong pressures on the financial position of developing countries that have accumulated a large debt burden in the years since the first oil crisis. For that and other reasons, the past six months and more have been characterized by interruptions in debt service by a number of large international debtors and strong pressures on the international financial system.

One danger has been that lending banks would attempt to protect their individual positions by rapidly retreating from new lending. But borrowers who have built up large debts over a period of years are not in a position to repay suddenly. An uncoordinated attempt to force such repayment would undercut the stability of the borrowers, the lenders, and the international financial system alike. We could not fully insulate our domestic banking and credit system -- and our own economy -- from such developments. Consequently, we have the strongest kind of self-interest in measures to contain and deal with the threat.

Management of that situation has required, and will continue to require, the active cooperation of borrowing countries, banks, central banks and treasuries of leading countries, and international financial institutions. The International Monetary Fund has a special, and indispensable, role to play. In that connection, I believe it is essential that the Congress approve an enlargement of the IMF's resources at an early date so that it can, with some assurance, proceed in the knowledge that its resources will be adequate to meet its responsibilities. As you know, that action will require increased budget authority, even though the operations of the IMF do not directly affect unified budget outlays or the deficit.

I look upon the proposed increase in IMF quotas and borrowing resources as a kind of insurance policy. If the need to draw on the added resources does not materialize, there will be no cost. But if the need does come about, we must be prepared to deal with it expeditiously. In that event, the provision of funds to the IMF will be reflected in additional borrowing needs by the Treasury. The extent to which those needs would be an additional net demand on credit markets is hard to foresee, because some of the funds are likely to, temporarily or more permanently, find their way back into dollar markets for investment, and the U.S. would be providing only a fraction of the funds required. More important, I believe the policies and performance of the IMF make clear that these funds would only be called upon to meet a clear threat to the orderly functioning of the international financial system. In those circumstances, the potential for disturbance to our domestic markets -- which cannot be insulated from international markets -- would be far greater from failure to provide resources to the IMF than from the limited amount of added Treasury borrowing. In other words, a strong IMF, with resources adequate to do the job, seems to me very much in our national interest.

Conclusion

I need not dwell on the fact that we are negotiating a most difficult period in our nation's economic history. But I also believe we are in the process of laying the base for more vigorous, and lasting, non-inflationary growth. In looking to the rest of the decade and beyond, there are, in my view, strong forces at work that can lead to a kind of self-reinforcing process of growth, greater price stability, higher real income and profits, and declining unemployment.

There are, to be sure, obstacles in the way. Monetary and fiscal policies alike need to be alert to those obstacles; working together, I am confident that they can be removed and that we can realize the bright opportunities before us.

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