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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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Mr. Chairman, and members of the Committee, I am pleased to appear before you today as you focus on the first Concurrent Budget Resolution for fiscal year 1985. I shall address myself briefly to the prospects and challenges that face us as we consider both monetary and fiscal policies for the remainder of 1984 and the years beyond. I believe we have much upon which to build in working toward long-lasting expansion. But it also seems to me evident that difficult decisions are necessary now to make that prospect a reality.

Over the past two years inflation has slowed dramatically, reaching the lowest rate in about a decade. The first of those years was a period of serious recession. But 1983 was a year of recovery stronger than most had believed was likely to occur. The increase of almost 6-1/4 percent in real output during 1983 was roughly in line with the postwar recovery norm, and the decline in unemployment has been even sharper than usual. The fact that we were able to achieve vigorous recovery while containing inflation is what is so promising for the future.

The pressures of recession, deregulation of some important industries, and import competition have all contributed to a greater sense of discipline and realism in pricing and wage bargaining. But we cannot, of course, claim success against inflation until we can combine greater price stability with prosperity over an extended period.

The chances of "building-in" greater stability will depend heavily on workers having the opportunity for gains in real earnings and on satisfactory corporate profits. The past two years have provided a more favorable setting in both respects. The real income of the average worker has risen as price increases slowed faster than wages. After-tax economic profits have recovered strongly and, relative to the GNP, are close to the highest years of the 1970's.

If these gains are to be maintained, we shall need productivity growth, we shall need a balanced expansion that avoids bottlenecks, and we shall need to encourage competition and investment.

There is some evidence that the dismal productivity trend of the late 1970's is changing for the better. Some of that evidence is qualitative or particular to one industry or another -- new efforts at cooperation between management and labor, more flexible work rules, and less regulation. On an aggregative level, the evidence, while not yet conclusive, suggests that we may be seeing not just typical cyclical gains in productivity but also more lasting improvement. Productivity gains from here on are likely to be smaller than those seen in the initial quarters of recovery. But there is also reason to hope that the skills of a more experienced work force, coupled with management innovations and technological progress, can sustain a somewhat more favorable trend over the years ahead.

That prospect is, of course, dependent in important part on new investment -- as is our ability to avoid bottlenecks. We have, indeed, seen a rapid increase in some types of investment during the recovery period. But so far, rising business investment has been largely concentrated in relatively short-lived equipment rather than in long-lived plant or major machinery that would add substantially to production capacity. Housing has also rebounded. But, overall, net new private investment has remained relatively low as a proportion of total GNP, as shown in Chart I attached.

As we move from recovery to the expansion phase of economic activity, business investment should rise over a broader front. Changes in tax laws enacted in recent years should work in that direction. But the question remains whether we can, as a nation, generate the supply of savings necessary to support both rising investment <u>and</u> a huge government deficit. That, it seems to me, is the key policy issue before us.

The importance of dealing with that issue is highlighted by several well-known facts. Interest rates are already high -- too high -- in absolute terms and relative to current price trends, tending to restrain those types of investment where interest costs loom large. In at least a few industries -- paper, certain plastic materials, some types of electronic equipment -- capacity constraints are already looming, and long lead times for investment mean that plans must be implemented soon to avoid bottlenecks and threats to noninflationary expansion. As the economy grows, more inventory investment will also be needed, adding another demand to our limited supply of savings.

For the time being, we have been able to supplement our domestic savings by drawing on a large capital inflow from abroad. But, as I will discuss a little later, that development carries risks and dangers of its own and cannot be sustained indefinitely.

Monetary Policy

I have recently reviewed in some detail with the Banking Committees our intentions with respect to monetary policy. In summary, the Federal Open Market Committee essentially reaffirmed the ranges for the monetary and credit aggregates for 1984 that were tentatively established last July. Those ranges call for growth of the broader aggregates, M2 and M3, between 6 and 9 percent and growth in M1 of 4 to 8 percent. These ranges, shown on Table 1, which is attached to my statement, are 1/2 to 1 percentage point below those for 1983.

The ranges for 1984 envisage that relationships between monetary and economic activity and inflation -- summarized in the "velocity" of money -- will broadly follow more normal trends and cyclical developments, after departing markedly from past patterns in 1982 and early 1983. On that assumption, monetary and credit growth should be fully consistent with real economic growth in 1984 in a range of 4 to 4-3/4 percent, provided that inflation, as anticipated, does not accelerate markedly. The gains in output are expected to generate a further expansion of new job opportunities and the unemployment rate is expected to decline to the area of 7-1/2 to 7-3/4 percent by year's end. These economic projections, which are "central" tendencies of projections of the members of the FOMC, are broadly consistent with the short-term projections of the Administration and the Congressional Budget Office.

We do intend, as the year progresses, to assess closely the relationship between monetary and economic activity and inflation, testing the assumptions and the analysis that suggest more normal "velocity" relationships are returning. In shaping policy, however, we are strongly conscious of the need to avoid any strong resurgence of inflationary pressures as the economy expands.

Economic projections extending several years ahead are necessarily more problematical. Both the Administration and the Congressional Budget Office have projected continuing growth, reduced unemployment, and, in varying degrees, limited further progress against inflation. Projections of that sort, as a basis for planning, seem to me reasonable. But we should not be deluded into mistaking a projection for a certainty -- or even a probability -- unless we are willing to take the measures reasonably necessary to achieve that end. Specifically, the way the final choices before this Committee are reached will bear critically on the chances of meeting those economic projections.

In this context, more rapid monetary and credit growth in an effort to speed progress toward lower interest rates would all too likely be counter-productive. The economy, driven in large part by the purchasing power implicit in the deficit, is already growing at a satisfactory pace. By feeding the concerns about inflation, excessive monetary growth would, in the end, have a perverse influence on interest rates. The resultant heightened fears of inflation and instability would only reduce incentives to save and the willingness of firms to make long-term commitments to productive investment. The continuing flow of funds from abroad, upon which we are dependent for the time being, would be discouraged. Depreciation of the dollar externally as a result of inflationary policies would not, in the end, help our exporters, or those competing with imports, because that depreciation would be accompanied by inflated domestic costs.

In a real sense, one key contribution that the Federal Reserve itself must make to our lasting prosperity is to foster the expectation -- and the reality -- that we can sustain the hard-won gains against inflation. In the end, that will set the stage for further lasting reductions in interest rates and a sustained, better balanced, expansion in economic activity generally.

The Role for Fiscal Policy

What we in the Federal Reserve cannot do, by manipulating the money supply, is to achieve a better balance between the demand for, and supply of, savings. That is the essential role for fiscal policy.

The state of the federal budget affects both directly and indirectly the demands on the economy. The increase in the deficit that was recorded last year helped account for the speed of the rebound in economic activity, even though interest rates, in historical terms, remained high. The deficit, in effect, increased purchasing power at a time when the economy was still feeling the effects of recession. However, as the economy has grown, the adverse effects of the imbalance of domestic savings and investment on credit markets and on our external accounts have become more apparent. And those imbalances can only worsen if deficits of the magnitude projected by the Congressional Budget Office and others -- deficits without precedent during a period of economic expansion -- are permitted to materialize in coming years.

The two charts I have attached to my statement illustrate the sharp difference between the present budget trajectory and previous periods of economic recovery and expansion. The first of those charts, summarizing sources and uses of available savings, shows graphically how the deficit in 1984 will continue to account for more than half of the demands for savings (net of depreciation). Those demands will, in fact, substantially exceed our capacity to save domestically -- an amount that for many years has fluctuated roughly between 6-1/2 and 8-1/2 percent of the GNP. Consequently, we are forced to increasingly look abroad for capital to supplement our domestic savings.

For some time, we have been able to draw upon foreign savings relatively easily. Funds have been attracted not just by our interest rates and by our strong stock market, but by relative confidence in our economic and political stability. The effect has been to blunt some of the impact of the budget deficit on our interest rates, and to help finance both the deficit and investment.

But, over time, reliance on increasing amounts of foreign capital is a tenuous and risky way to finance domestic growth and capital formation. It exacts a large cost in terms of rising trade and current account deficits -- deficits that cannot be sustained indefinitely. Moreover, a steady and growing flow of foreign capital is dependent on confidence in our ability to properly manage our economic affairs, on relatively high interest rates, or both. To the extent our monetary or fiscal policies fail to justify that confidence -- to the extent inflationary pressures again appear to be ascendant or our external financial position is steadily weakened by large foreign borrowings -- the greater the risk that new capital flows from abroad will come less freely, with adverse consequences for the dollar and for interest rates.

The second chart underscores the extraordinary nature of our present fiscal position. In only one earlier recession period -- 1975 -- did the Federal Government absorb so large a share of total credit flows, and in every postwar economic cycle, borrowing by the Treasury diminished substantially as a share of total credit flows during the second year of recovery. In contrast, the fraction of credit going to the Treasury, at 35 to 40 percent, will not decline much, if at all, this year from the unusually high level we saw in 1983.

To put the point another way, Treasury debt is expected to increase about 17 to 18 percent this year. Assuming credit grows about 10 percent this year -- just above the mid-point of the FOMC's range -- all other demands for credit could rise by some 8 percent, no more than in 1983 (the first year of recovery). This would be an unusual cyclical pattern.

The Treasury is going to get the funds it needs to cover the federal deficit. The question is whether other sectors will get enough funds, at reasonable interest rates, to support the balanced, higher investment, expansion we want. To some extent, improved profits and cash flow, relative to other recent expansions, could help forestall excessive pressures. But the kind of expansion we and others forsee does imply more business borrowing, and housing and consumer credit needs -- increasing by 11 and 15 percent, respectively, over the last half of the past year -- are already expanding rapidly.

In essence, the demands of the Federal Government limit the rate of growth of other credit-absorbing sectors of the economy. The rationing device is interest rates held higher than would otherwise be the case. Under the circumstances, the more rapidly the economy grows and generates private credit demands, the greater the risk of rising interest rates.

We can, in concept, visualize an economic expansion that continues despite financial strains -- an expansion characterized by relatively high interest rates and by high consumption supported by large deficits, but markedly sluggish investment and a widening trade deficit. That, in itself, is hardly desirable, in terms of the staying power of the expansion and future growth and productivity. But we also have to be conscious of the added risks such financial pressures would pose -- to thrift and other financial institutions, to less developed countries with heavy debt burdens, and their creditors in the U.S. and elsewhere, and to the fabric of international trade. At some unknown point the sustainability of the expansion itself would be jeopardized.

We cannot reasonably escape from these problems by "monetizing" the Treasury debt through excessive expansion of bank credit and the money supply. The Federal Reserve, could, in concept, take an approach which inflated all the numbers, but it cannot increase savings and reduce the savings-investment imbalance by undermining confidence. What must be done is to deal with the source of the problem -- the excessive deficits. While it is already late to make significant changes for fiscal year 1984, action now affecting fiscal 1985 and later years can only work in the direction of moderating potential pressures; if sufficiently forceful, the market could then well anticipate the time the actions become effective. At the least, the risks of eroding confidence and new market pressures should be relieved.

I know you are aware of another reason why expeditious action to reduce deficits is desirable: the large deficits now being projected can be self-perpetuating.

The direct effects are obvious. Interest payments on debt issued to finance this year's deficit add to the deficit next year, and interest payments on those deficits increase exponentially into the future, making it more difficult to reverse the momentum.

Let me illustrate the point somewhat differently. The Administration and the CBO's estimates of the Administration's budget program differ in considerable part because of the underlying economic assumptions used. Specifically, the higher deficit forecasts of the CBO assume that interests rates will not decline as much as the Administration, compounding the effects of higher deficits originating from other factors. But, if we seize the opportunity to take stronger and early positive action to reduce the deficit, and that action helps encourage lower interest rates than projected by the CBO, then the deficit can be placed on a trend more in accord with Administration estimates. In other words, procrastination plainly exacerbates the problem, leaving us all with still more difficult choices not very far down the road.

Somewhat less obvious may be new budgetary pressures arising out of the attempts of various special interests -- consumers, workers or firms -- to offset the effects of sustained high deficits on our international competitive position and on interest rates. For example, the deterioration in the position of our industrial and farm products in world markets is already generating demands for subsidies, tax relief and special protections for economic sectors as diverse as the family farm and the steel industry. The effects of high interest rates on construction and housing costs call forth requests for new programs in those areas.

I suspect all of this is, by now, familiar to you. The real obstacle to action is not intellectual, but the difficulty of reaching a practical consensus on specific spending or revenue measures to deal with the problem. In a sense, dealing with the deficit seems to be everyone's second priority -- the first is particular spending programs or measures of tax relief that, viewed in isolation, have strong justification.

Decisions in those areas -- with political as well as economic dimensions -- are not within the competence of the Federal Reserve. I can only urge that they be faced sooner rather than later before we are enveloped with an atmosphere of crisis, in financial markets and elsewhere.

Much has been achieved in these last few years to put the economy on a sounder footing -- too much, at too great a cost -- to see it all jeopardized now. The risks arise mainly from our own actions -- or inaction. The amounts required to make a real difference -- to bring the trend of deficits under control -- are surely not beyond reach. It has been done in the past, and it can be done again.

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Table 1

Summary of Federal Reserve Monetary and Credit Growth Objectives and Economic Projections for 1984

Objectives for Money and Credit Growth[1]

	New ranges for 1984 (%)	Tentative ranges for 1984 set in July 1983 (%)	Ranges for 1983 established in July 1983 (%)
M2	6 to 9	6-1/2 to 9-1/2	7 to 10[2]
M3	6 to 9	6 to 9	6-1/2 to 9-1/2
M1	4 to 8	4 to 8	5 to 9[3]
Domestic Nonfinancial Sector Debt	8 to 11	8 to 11	8-1/2 to 11-1/2

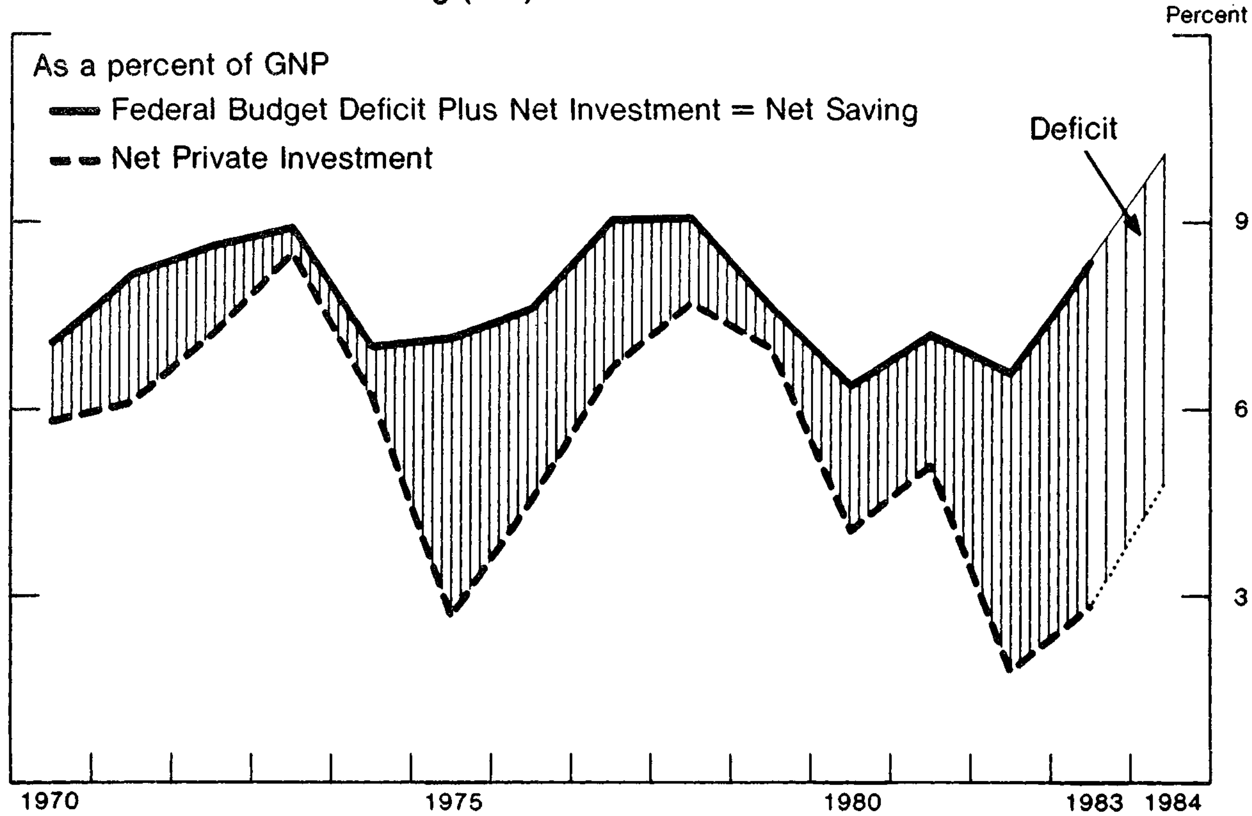
1. Ranges apply to periods from fourth quarter to fourth quarter, except as specified.
2. Range applies to period from February-March 1983 to fourth quarter of 1983
3. Range applies to period from second quarter of 1983 to fourth quarter of 1983.

Economic Projections for 1984

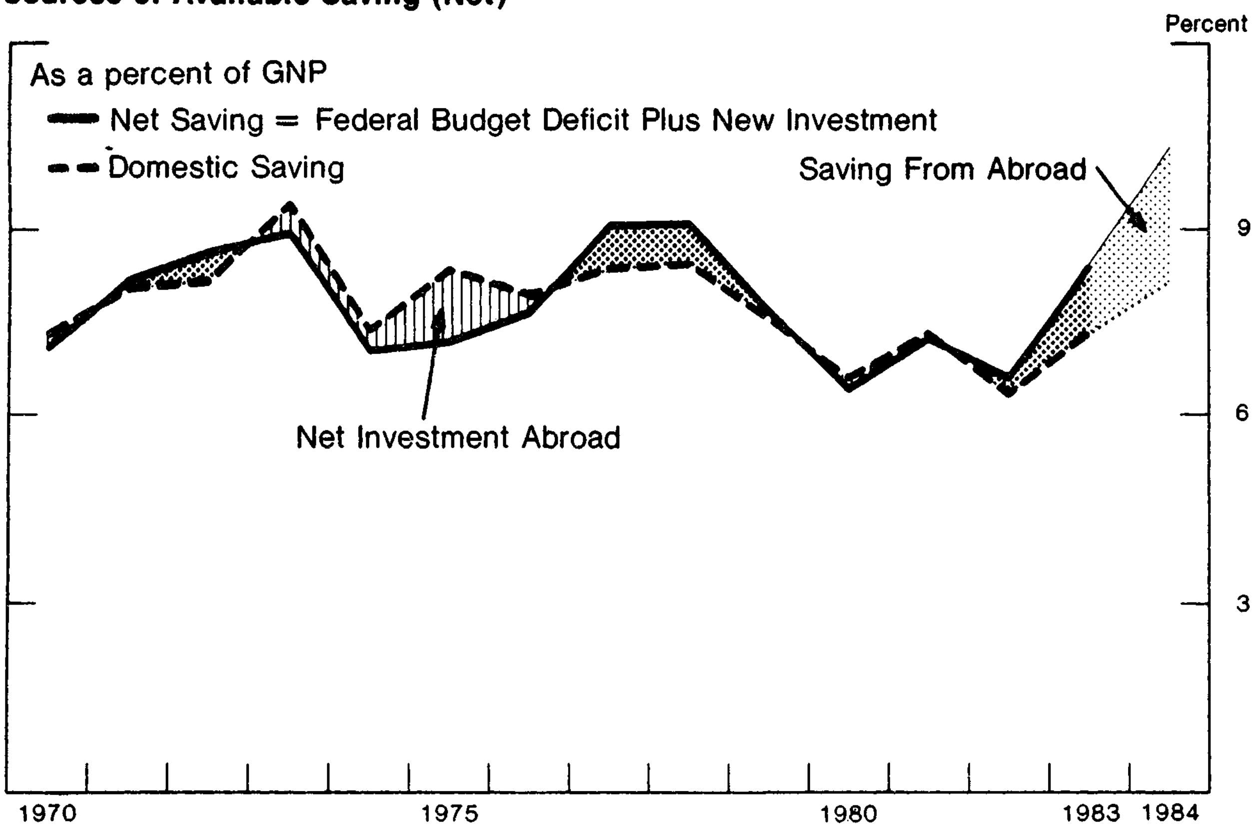
	FOMC members and other FRB Presidents		Adminis-tration
	Range	Central tendency	
Change, fourth quarter to fourth quarter (%)			
Nominal GNP	8 to 10-1/2	9 to 10	9.8
Real GNP	3-1/2 to 5	4 to 4-3/4	4.5
GNP deflator	4 to 6	4-1/2 to 5	5.0
Average unemployment rate in the fourth quarter (%)	7-1/4 to 8	7-1/2 to 7-3/4	7.7

Chart I

Demands on Available Saving (Net)



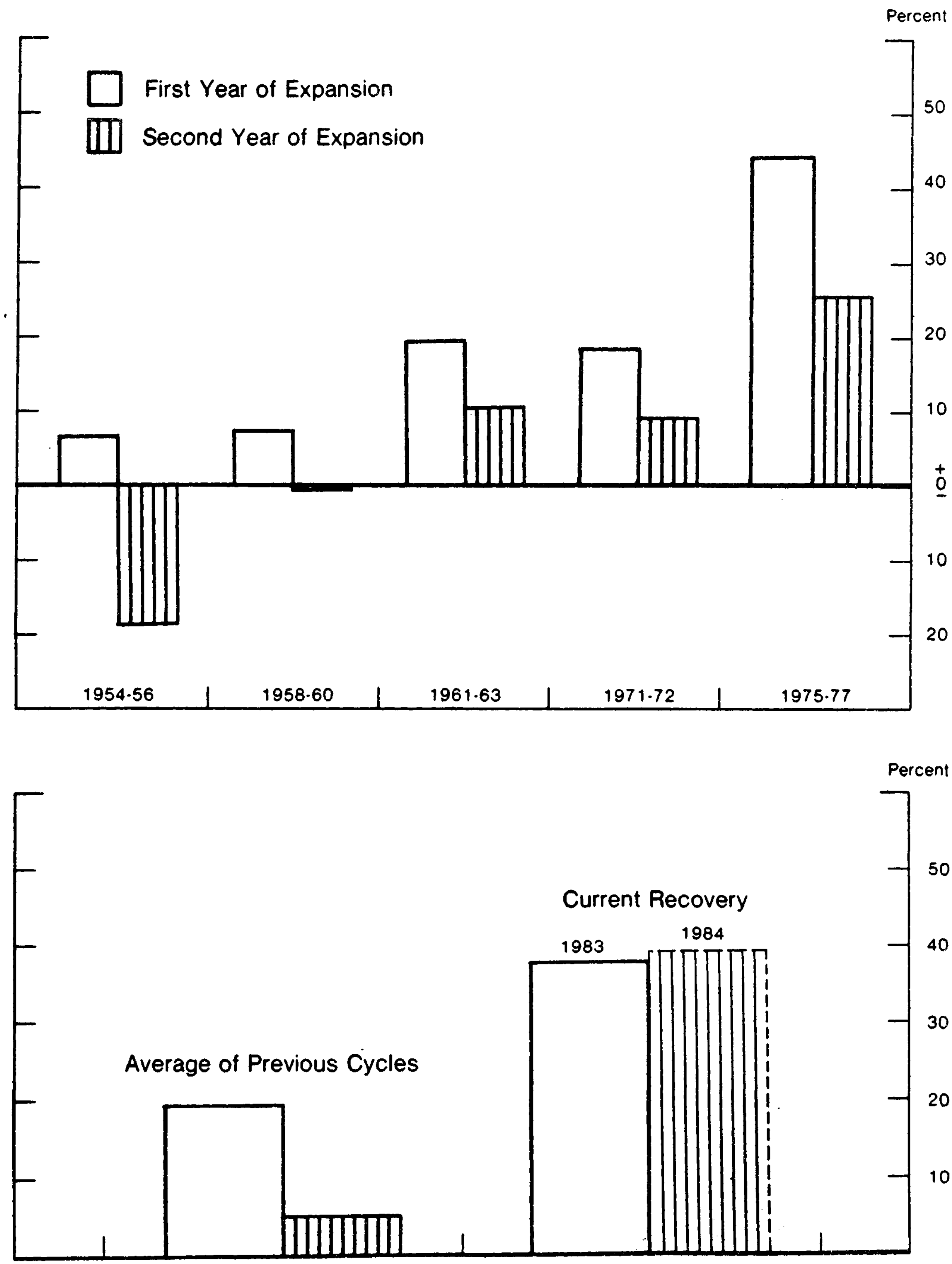
Sources of Available Saving (Net)



Note: 1984 figures based on FOMC members' projections for the economy and estimates of the federal budget. Saving from abroad essentially equals the current account deficit.

Chart II

Share of Total Credit Taken by U.S. Government*



* Net borrowing by U.S. Treasury as a percent of total credit flow to domestic nonfinancial sectors.