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Statement by

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before the

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I am pleased to appear once again before this Committee to discuss the economic situation. As you know, the Federal Reserve will be submitting its semi-annual report on monetary policy to the Congress in about two weeks. My testimony then will provide a full account of recent monetary developments and will report on the decisions to be taken shortly by the Federal Open Market Committee regarding money and credit targets for 1985. Therefore, in my prepared remarks this morning, I will limit myself to a broader view of the current economic setting, with some emphasis on the interrelationships between domestic and international developments.

Two years ago, when the current business expansion was just beginning, I expressed to this committee my belief that, through a difficult period of economic and financial adjustment, we had potentially been laying the groundwork for sustained growth and prosperity. I felt then, and I feel now, that restoring and maintaining a greater sense of price stability would be central to that effort.

Today, I think it is fair to say that bright promise for the longer run remains. Economic growth has in fact been strong over the past two years, and inflation has remained at or very close to the much lower levels reached at the start of the recovery period. As 1985 started, most observers have shared the view that prospects for further growth remain good, and expectations of stronger inflationary pressures as the expansion period is extended, quite prevalent earlier, have been at the least muted.

Nonetheless, clear risks and obstacles remain to making good on our own potential both for stability and growth, and to accomplishing that, as we must, in the context of a more prosperous world. To a considerable degree, the "buts" and "ifs" are well understood. Yet, that intellectual understanding will be for naught if the appropriate policy responses are lacking, whether because of unwarranted complacency bred by current performance, because of the inherent political difficulty of reaching the necessary consensus, or because of some combination of the two.

The Evidence of Progress

The clearest evidence of progress toward our long-run aims lies in the combination of better than anticipated growth and lower than anticipated inflation over the past two years. To be sure, the current expansion began from a low level, and unemployment has not yet been reduced to levels we have enjoyed historically and want to regain. But after widespread doubts about our economic prospects, the recovery of 1983 has blossomed into what has been one of the strongest expansions of the postwar period.

Real gross national product grew more than 5-1/2 percent over the course of 1984, bringing the cumulative gain in domestic output over the past two years to about 12 percent. The rise in production has been associated with an increase in employment of more than 7 million since the end of 1982, and the unemployment rate has fallen about 3-1/2 percentage points over that period, to around 7-1/4 percent. As part of that general improvement, there has been a sharp rebound in profits and a surge in business investment, factors that should bode well for our future growth potential. Spending for innovative, high-technology capital has grown especially rapidly. Productivity has grown more strongly, although there are still important questions as to how much the underlying trend has improved.

The recent monthly data on consumer and producer prices continue to show only very small increases for a wide range of goods. For some important commodities, including petroleum and a number of raw materials, price declines have been more common than price increases. Prices of most services have continued to increase at a substantially more rapid rate -- averaging 5 to 6 percent at the consumer level. Most of our economy today is, in fact, a "service" economy. Those services are generally subject less directly to competitive pressures from overseas. Moreover, labor intensive sectors of the economy, such as many services, may have less opportunity for productivity growth. Nevertheless, the rate of price increase for services has been significantly less than in the late 1970's and the first years of the 1980's.

Further improvement will be necessary in these areas to maintain progess toward stability. In a direct sense, that depends in considerable part on whether the rate of nominal wage increases continues to decline in service industries to levels more characteristic of the rest of the economy.

With inflation down, workers generally have apparently felt less need to press for large increases to make up for past price increases or to stay ahead of expected inflation. Businessmen and workers in manufacturing, mining, and construction have also recognized that they often operate in a more competitive and more international environment -- one in which there are obvious perils in rising costs and prices and a premium on efficiency. The restraint on wages and costs generally need not mean, however, reduced prospects for gains in real income. To the contrary, the "payoff" in a growing economy, with rising productivity and more stable prices, is more jobs and higher real incomes for the average worker.

Success in containing inflation can help to breed further success. It is indispensable to prospects for achieving and maintaining a lower level of interest rates, which, despite declines in recent months, have remained historically high. Over time, expectations of greater price stability should become increasingly woven into the fabric of household, business, and financial decision-making. Efficiency and productivity should benefit as less energy is spent in the largely futile search for ways to "beat" inflation. Pressures for "precautionary" wage and price increases have diminished. As borrowing and lending horizons are lengthened, the financial structure should be strengthened, and less "inflation insurance" will be built into long-term interest rates.

Obstacles and Risks

After all the disappointments of the past with failed anti-inflationary efforts, that process inevitably takes time. Meanwhile, we cannot simply assume that inflation has been conquered, or that we have in fact reached a new era of sustained growth. There are still too many obstacles to permit that kind of satisfaction.

To put it bluntly, there are large and unsustainable imbalances in our economy, and in the world economy. In the midst of the overall improvement that I cited earlier, those imbalances are reflected, for instance, in the intensity of the strains in agriculture and in a number of other basic industries. There have been exceptionally high levels of unemployment in many other industrialized countries, and, looking ahead, too few signs of really significant improvement in that respect. That outlook bears on our own markets. Moreover, the financial position of the heavily indebted developing countries remains vulnerable, and their difficulties can feed back on our economic outlook and financial system. And, as I noted earlier, interest rates remain high relative both to historical experience and to recent rates of inflation.

These difficulties arise in part out of structural problems unique to one sector or another, and to that extent must be addressed at that level. The painful pressures on some businesses, farms and financial institutions also reflect the strain of adjusting to a less inflationary environment, when their financial decisions had, implicitly or explicitly, been based on expectations of accelerating inflation. But these strains are being aggravated by financial pressures and dislocations related to our budgetary problems. Until that underlying problem is dealt with appropriately, we will unnecessarily be putting at risk all those bright prospects for stability and growth of which I have spoken.

The distortions in the economy are manifest in our massive trade and overall current account deficits, which reached levels of almost $110 billion and $100 billion, respectively, during 1984. It is not a coincidence that those external deficits are accompanied by an enormous internal budget deficit -- a deficit that, according to both Administration and Congressional Budget Office estimates, will tend to grow further in the absence of corrective action even assuming healthy economic growth.

Given the deep recession and high levels of unemployment in 1982, the sluggishness of the world economy, and the strains on developing countries, sizable deficits in our budget and trade accounts could and did serve an important transitional function in helping to encourage recovery here and abroad. Specifically, the domestic deficit helped sustain and increase domestic purchasing power, and the more favorable tax treatment for investment helped encourage capital spending. The growth of our markets has probably been the single greatest expansionary force for other countries over the past two years, and our economy absorbed the brunt of the necessary efforts of the heavily indebted Latin American countries to restore external financial and economic equilibrium.

At the same time, the strength of the dollar in the exchange markets, together with the ready availability of goods from abroad, have been potent factors in damping inflationary forces and satisfying our consumption demands.

What then, it might be asked, is the difficulty? Why not rest content?

The answer, most fundamentally, is that economic analysis and common sense coincide in telling us that the budgetary and trade deficits of the magnitude we are running at a time of growing prosperity are simply unsustainable indefinitely. They imply a dependence on growing foreign borrowing by the United States that, left unchecked, would sooner or later undermine the confidence in our economy essential to a strong currency and prospects for lower interest rates. At the same time, the hard fact is that the budget deficit, on top of the private investment needed to support growth and productivity, outruns our internal savings potential. The largest and richest economy in the world has perforce been required for the time being to draw on savings generated abroad; in that real sense we are living beyond our means. As we continue to draw so heavily on the world's savings, there is a drag on internally generated expansion elsewhere, feeding back on our trading prospects. And, the resulting imbalances and financial strains generate political pressures, here and abroad, for counter-productive protectionism, for economic nationalism, and for excessive money creation that would, if implemented, undercut and jeopardize all the progress we have made.

The External Dimension

While much of our rhetoric still skirts the issue, the time has passed when we can intelligently assess our performance and our policies without considering the external dimension -- the implications for international trade and capital flows, exchange rates, and economic and financial conditions elsewhere. Like it or not, world financial markets and economies are integrated as never before. Over time, I believe, we derive enormous benefits from that fact. But it imposes disciplines of its own.

The complications in analysis and the potential for good or ill were amply illustrated in 1984. As you know, the growth of economic activity slowed abruptly during the summer and early fall. Following the exceptionally rapid growth over the first half of the year, some slowdown should not have been surprising, given the fluctuations in consumption and inventory imbalances common as an expansion period is extended. By year end, there was evidence once again of more positive trends in household spending and some inventory imbalances appeared to be at least partially corrected.

But as domestic demands slowed, the more fundamental imbalances remained and became more obvious. Throughout this recovery, domestic purchases of goods and services have increased faster than domestic production. In essence, a lot of demand generated in this country has flowed abroad through our rising trade deficit, providing stimulus for production overseas rather than in this country. The increase in imports didn't seem to matter much so long as output and employment generally were expanding so rapidly. But, even then important sectors of the economy, in a real sense, did not share at all fully in the overall recovery, with trade pressures aggravating deep-seated structural problems. As soon as domestic demand dropped from the extraordinarily rapid rate of the first half of the year, the effects of the demand slowdown on production were amplified by the rising trade deficit.

From 1982 to the second half of 1984, the current account deteriorated by about $100 billion, pushing us into an external deficit equivalent to 2-1/2 to 3 percent of the GNP. Just as for a household or business, current spending abroad can exceed current income only to the extent that we can draw on foreign assets or debt is increased. As a consequence, the United States is in the process of moving from the world's largest creditor to the world's largest debtor.

Thus far in the expansion, the net inflow of capital needed to finance the current account deficit has been readily forthcoming, so much so that the dollar exchange rate has persistently strengthened even as the U.S. current account has deteriorated. No single factor appears to account for that flow. Relatively high interest rates in this country, our success in reducing inflation, and perceptions of political stability and economic vitality all have contributed. But political and economic uncertainties abroad appear to have played a part as well.

The strong flow of funds from abroad has been a key factor helping to ameliorate financial stresses in this country, as expansion generated large new demands for private financing on top of the continuing Federal deficit. Two tables attached to my statement illustrate the point.

As indicated there, net domestic savings -- personal, business, and state and local government -- have increased appreciably as the economy has expanded. The ratio of net savings to the GNP is near the top of its historical range. But those domestic savings have not been nearly enough to finance both rising private investment and the Federal deficit. Those requirements, relative to the gross national product, have risen about 4-3/4 percentage points in the past two years to about 11-1/2 percent of the GNP. far above past relationships. About half of that increase was met by higher savings from abroad.

I don't believe we can escape the conclusion that, without the ready availability of savings from the rest of the world, pressures on our financial markets would have been greater and domestic interest rates would have been still higher, at some point undermining the outlook for domestic housing and investment.

The kind of obvious "crowding out," so widely anticipated a year or two ago, has been avoided. But, in a real sense, important sectors of our economy are paying the price. Those dependent on foreign markets and those competing with imports are being "crowded." To put the point in perspective, the $100 billion deterioration in our current account -- a measure of "lost" markets for U.S. producers -- is equivalent in size to about two-thirds of the entire residential housing sector.

As I emphasized earlier, viewed in a world context, our ability and willingness to run a sizable trade and current account deficit during a period of strong domestic recovery had constructive implications for others. But, as we look ahead, neither we nor other countries can expect growth to be maintained indefinitely on a shaky foundation of large and growing trade deficits, massive capital flows to the United States, and accelerating international indebtedness.

The visible strains in some sectors of our economy and interest rates that have remained historically high are clear warning signals. Perhaps less obvious but nonetheless real, the drain of savings from other countries to the United States and the related tendency for their currencies to depreciate vis-a-vis the dollar, appear to be inhibiting more forceful policies to encourage "home grown" expansion abroad. A healthy world economy -- and better export markets for the United States -- are ultimately dependent on that expansion. The dilemma is that so long as demands on our own capital markets exceed our capacity to save, the stability of our own financial markets is, in effect, hostage to a large continuing inflow of foreign capital.

That flow, in turn, is dependent on the maintenance of confidence in our own prospects and in our own currency. But so long as the imbalance in our trade persists and increases, the greater the risk that that confidence will be eroded, disturbing our financial markets and jeopardizing our growth. It is that apparent inconsistency that must be confronted.

The Role of Monetary Policy

While I will be testifying with respect to Federal Reserve policy in some detail shortly, a few general observations about monetary policy are appropriate in this context. That policy, in most general terms, is directed toward encouraging the process of restoring price stability while providing enough money to support sustainable growth in demand and output. Reasonable progress in those directions was made in

1984. Indeed, the strength of the dollar, despite the larger current account deficit, helped to reconcile strong growth in demand over the year as a whole with restraint on prices. But, as I indicated a few moments ago, the rising trade deficit, as more of the domestically generated demand spilled over abroad, clearly raises questions of the sustainability of a process dependent on large inflows of capital.

Monetary policy can stimulate growth in the money supply, but it cannot create the real savings necesary to finance high levels of investment and excessive budget deficits simultaneously. That depends upon all the factors inducing individuals and businesses to save for the future. Efforts to, in effect, paper over the difficulty by financing the huge budget deficit by excessive money creation would surely be counter-productive. We would undermine the growing confidence in prospects for stability. That confidence is a necessary ingredient in any effort to see lower interest rates in the years ahead. It is also essential to maintain the flow of capital from abroad upon which we are for the time being dependent.

In sum, I see no realistic escape from our dilemma by reverting to inflationary monetary policies. They could only accelerate the disturbances we want to avoid. Indeed, without action on the budget and other fronts, the possibility of a reduced flow of capital from abroad would, if it materialized, constrict the flexibility of monetary policy.

The Protectionist "Solution"

The current trade imbalances and the strong pressures on particular economic sectors certainly lead to strong pressures for protection from affected industries. But that approach toward "relief" is symptomatic, not fundamental. Indeed, yielding to those pressures could only aggravate the difficulties, so long as the underlying financial imbalances persist.

Suppose, for instance, strong protectionist measures actually had a pronounced effect in closing our trade deficit. Then, the capital inflow from abroad would also be reduced, and interest rate and inflationary pressures increased. The benefits to one industry would be offset by greater financial market pressures and damage to others. Or, if the capital inflows were maintained the dollar would presumably be driven still higher, shifting the burden to exporters and unprotected industries.

More realistically, protectionism here would be matched, or more than matched, abroad, with devastating consequences for world trade and growth.

A Constructive Approach

One lesson of our experience seems clear. The progress that has been made toward greater efficiency, cost restraint and innovation needs to be continued and encouraged by public policy in a variety of ways rather than discouraged by a retreat into protectionism or new permanent Federal subsidies that distort the economy and aggravate the deficit.

I do not want to suggest all the burden of sustaining a favorable economic climate and restoring external equilibrium rests on the United States. A number of industrialized countries might reasonably review their own possibilities for stimulus in the light of their high levels of unemployment and rather sluggish growth, and they could constructively work to remove the structural impediments to their growth. There is too much protection of markets abroad, and the efforts to deal with that need to be maintained.

There is no single "magic pill" to restore equilibrium and assure growth. But neither can there be real doubt that it is within our capacity to take a large step, here and now, to ease the necessary adjustments in agriculture and industry at home, to make us less dependent on foreign savings, to improve trade prospects, and thus to reinforce prospects for growth and stability. That step would be to make decisive reductions in our budget deficit. Those reductions, to be credible, should be large enough and assured enough to have an impact on expectations and confidence, even if they cannot be fully effective for some time.

That is, of course, by now a familiar plea -- but it is no less urgent for its familiarity. To the contrary, the sharply increased size of our external deficit, the tendency for the budget deficit to grow even as the economy expands strongly, and the still high interest rates, should be warning enough that we are on an ultimately unsustainable path.

Deficits that are relatively benign in the depths of recession or in the early stages of recovery turn destructive at a time of relative prosperity. They are reflected in imbalances in our own economy. At the same time, our dependence on foreign savings can only impede the prospects for self-sustaining growth abroad -- and we cannot indefinitely be virtually the only engine for world expansion.

Action now, and action large and forceful enough to be seen to be decisive, is the constructive way to resolve the impasse and to work toward international balance. In the process, it will help enormously to ensure those bright prospects for growth and stability of which I spoke at the start.

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TABLE 1

DEMANDS ON NET SAVING AND SOURCES OF NET SAVING
(Percent of gross national product)

	Total	Demands on net saving: Net private investment[1]	Demands on net saving: Federal budget deficit[2]	Sources of net saving: Domestic[3]	Sources of net saving: Foreign[4]
1974	7.0	6.2	0.8	7.2	-0.2
1975	7.1	2.7	4.5	8.3	-1.2
1976	7.6	4.5	3.1	7.9	-0.3
1977	9.0	6.6	2.4	8.3	0.7
1978	9.1	7.7	1.4	8.4	0.7
1979	7.6	7.0	0.7	7.6	0.1
1980	6.4	4.0	2.3	6.6	-0.2
1981	7.2	5.0	2.2	7.4	-0.2
1982	6.7	1.8	4.8	6.5	0.2
1983	8.2	2.8	5.4	7.2	1.0
1984(p)	11.4	6.6	4.8	8.9	2.6

p = preliminary
1. Net private investment is the sum of business fixed investment, residential construction outlays, and the change in business inventories, less depreciation, minus a statistical discrepancy.
2. NIA basis.
3. Domestic net saving includes personal saving, undistributed corporate profits, and state and local government surplus.
4. Equals payments to foreigners for imports of goods and services, transfer payments, and interest paid by government to foreigners minus receipts from foreigners for exports of goods and services.

Note: These figures exclude depreciation, which amounted to $403 billion in 1984; including depreciation would raise both domestic investment and domestic saving.

Source: Calculations based on data from the National Income and Product Accounts.

TABLE 2

DEMANDS ON NET SAVING AND SOURCES OF NET SAVING
(Billions of dollars)

	Total	Demands on net saving: Net private investment[1]	Demands on net saving: Federal budget deficit[2]	Sources of net saving: Domestic[3]	Sources of net saving: Foreign[4]
1974	100.4	88.9	11.5	103.3	-2.9
1975	110.6	41.3	69.3	128.8	-18.3
1976	130.8	77.7	53.1	135.9	-5.1
1977	173.4	127.5	45.9	159.7	13.6
1978	196.1	166.7	29.5	181.8	14.3
1979	184.6	168.5	16.1	182.8	1.8
1980	167.7	106.4	61.2	174.0	-6.3
1981	212.6	148.3	64.3	218.4	-5.8
1982	204.6	56.5	148.2	198.1	6.6
1983	272.6	94.0	178.6	238.7	33.9
1984(p)	419.0	242.6	176.4	324.5	94.5

p = preliminary
See table 1 for footnotes.