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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Senate Budget Committee

February 8, 1985

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I am pleased to appear once again before this Committee to discuss the economic situation, and in that context some implications of the budgetary choices you must make for the economy, for financial markets, and for our international position. I realize the task that confronts you in dealing with the budgetary position is extremely difficult. Those difficulties are matched by their significance for the well-being of our economy and, indeed, of the world economy generally.

Earlier this week I testified before the Joint Economic Committee. That testimony reviewed our economic progress, the obstacles and risks before us, and attempted to place questions of monetary and fiscal policy in that setting. I have submitted copies of that statement to the Committee and will not repeat it this morning.

Suffice it to say that the past two years have demonstrated highly encouraging progress toward returning the economy to a path of sustained growth and stability. Most observers

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concur that the immediate prospects remain favorable. But at the same time there are large imbalances in our economic performance and points of severe strain here and abroad. There are particular factors helping to account for many of those strains, and they must be dealt with directly. But it is also true that most of those specific difficulties are reflected in and aggravated by our twin deficits -- in our budget and in our external trading accounts. Those two deficits are themselves related to each other.

Until those underlying problems are adequately addressed, we will be putting at risk our hard-won gains and the bright promise for the future. It is difficult for me to see a constructive solution to those problems without going to their source. The implication seems to me clear -- we need to deal effectively with the reality of an enormous budget deficit at a time of growing prosperity and with the clear threat that, left untended, that deficit will rise over future years even in the context of a growing economy.

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As background for your deliberations, I would emphasize the linkage of our budgetary posture to the external side of the economy. The simple fact is we can no longer view our economy in isolation from the rest of the world. As you know, the imbalances in our economy are most obviously manifested in our massive trade and current account deficits, which reached about $110 billion and $100 billion, respectively, during 1984. It is not a coincidence that these external deficits have developed alongside the internal budget deficit.

That budget deficit, together with the rising investment needed to support growth and productivity must be financed either internally or externally. We do not have the capacity now or prospectively, given the size of the federal deficit, to save enough domestically to meet those needs. We have become perforce dependent on a growing net inflow of foreign savings to supplement our own.

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The two tables attached to my statement illustrate the point. Even as domestic savings have grown, about one-quarter of our net needs for investment and for deficit financing have had to be met from foreign sources. So far, that capital has been readily available, partly because more new funds have poured in from abroad and partly because our banks are lending less to other countries. That flow has had the effect of containing pressures on interest rates and on our capital markets, even though interest rates, as you know, have remained high historically and relative to the current rate of inflation.

But the implications of that capital inflow are not all favorable, and the adverse implications are mounting. The mirror image of a capital inflow is the trade and current account deficits, with adverse impacts on all those industries that look to export markets or that compete with imports. One effect is sizable sectors of the American economy have not participated at all fully in the recovery. The drain on foreign

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savings and the related depreciation of their currencies vis-a-vis the dollar, seem to be inhibiting prospects for internally generated growth abroad. At the same time, our capital markets and interest rates have become hostage to a continuing flow of foreign capital. Over time, the interest cost of those foreign borrowings will compound upon themselves.

A basic objective of monetary policy is, of course, to provide enough money to sustain growth in domestic demand in a framework of moving toward greater price stability. Sometimes the suggestion is made that we can go further and somehow resolve the imbalance between domestic savings and investment by expanding the money supply. But printing money is not a substitute for the real savings necessary to finance high levels of investment and budget deficits simultaneously. Excessive money creation would be counterproductive in two respects. To the extent it stirred new inflationary fears, after all the progress that has been made, those fears would sustain the level of

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interest rates and even drive them higher. By undermining the growing confidence in prospects for stability, it could discourage the capital inflow on which, for the time being, we are dependent.

The Federal Reserve, the Administration and the Congress have no magic wands to restore equilibrium and to assure growth in one easy stroke. Efforts must be made in a number of directions to sustain the bright promise of the economy. But the key ingredient in the policy mix seems clear enough. Steps now toward decisive, creditable reductions in our budget deficits -- large enough to have an impact on expectations and confidence in markets -- would provide the necessary sense of reassurance while working to alleviate the underlying imbalance between our capacity to save and the demands on those resources.

I am sensitive to the difficult, practical and political decisions that must be made. But I also know the

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longer the choices are delayed, the greater the risks and the larger the task. As we saw in the 1970's, confidence can be a fragile thing. It needs to be nourished and defended.

It will take action, and strong action, to get the deficit on a downward trend. Then growth can help to do the rest. And your action on the budget will help enormously in assuring that growth can be sustained in a framework of greater price stability.

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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		Sources of net saving	
		Net private investment[1]	Federal budget deficit[2]	Domestic[3]	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.

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TABLE 2

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

	Total	Demands on net saving		Sources of net saving	
		Net private investment[1]	Federal budget deficit[2]	Domestic[3]	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.

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