Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

U.S. House of Representatives

March 6, 1985
I am pleased to appear once again before this Committee to discuss the economic situation and its relationship to the budgetary choices before you. I know the task that confronts you in reconciling budgetary priorities in the context of a huge deficit is extremely difficult. I can shed little light on the choices you must make among national security, social, and other programmatic objectives. But from my vantage point, it does seem clear that an adequate reduction in the overall deficit must be a critical ingredient in any satisfactory budget plan.

Last month the Federal Reserve submitted its semi-annual report on monetary policy to the Congress, and my testimony to the Banking Committees at that time provided an extensive review of recent monetary developments and the Federal Reserve's expectations for the performance of the economy in 1985. I have submitted copies of that earlier testimony to this Committee, and I shall limit my prepared remarks this morning to some summary comments on the economic setting.
As you know, we have made substantial progress over the past two years toward our longer-run aims for the economy. Despite widespread doubts about our economic prospects at the beginning of the recovery, the expansion that developed has been the strongest since the Korean War period. Real gross national product rose almost 6 percent over the four quarters of 1984, bringing the cumulative gain in domestic output since the recession trough in late 1982 to about 12-1/2 percent. The rise in production has been associated with large increases in employment and a sizable decline in the unemployment rate. As part of that general improvement, there has been a sharp rebound in profits and a surge in business investment, especially for innovative, high-technology capital equipment. Productivity also has grown relatively strongly. Taken together, those factors should bode well for our future growth potential.

I am particularly encouraged by the fact that this remarkable expansion of activity has been achieved without any significant increase in the inflation rate from the
sharply reduced levels of 1982 and 1983. To be sure, a number of factors that may not be lasting have helped to hold down price increases. The continuing appreciation of the dollar and competition from imports have placed considerable downward pressure on prices in some manufacturing and mining industries. Declines in prices of some important commodities, including petroleum and a number of raw materials, also have played a key role. But perhaps more fundamentally, increases in nominal wages are reflecting and supporting the lower rate of inflation, and there are encouraging signs that expectations of future inflation have been damped.

At this point, the most common forecasts suggest that growth will remain strong enough in 1985 to produce some further declines in unemployment, with little if any pickup in inflation. That, in fact, is the "central tendency" of the Federal Open Market Committee members' forecasts. But we must not be lulled by these seemingly favorable near-term prospects. Despite the strength indicated by the aggregate
statistics and favorable near-term expectations for the economy as a whole, there are some large and unsustainable imbalances in our economy. Unless dealt with effectively, those imbalances will, in time, undercut all that has been achieved.

The strains in agriculture, the heavy capital equipment area, and the metals industry are most visible. To some extent, the difficulties in these sectors arise out of severe structural problems that must be dealt with directly. But there can be little doubt that these specific problems have been exacerbated by pressures related to the massive deficits in the federal budget and in our external accounts.

It is not a coincidence that the unprecedented large deficits in our trade and current accounts have developed alongside the internal budget deficit. In the end, a government deficit must be financed, either internally or externally, out of savings. We do not now, nor are we likely to in the future, have the capacity to save enough domestically.
to finance both federal deficits at or approaching the current size and the rising levels of investment needed to support growth and productivity. Thus far in the expansion period, we have been able to bridge the gap by drawing on a growing net inflow of foreign saving to supplement our own.

Net domestic saving -- by individuals, by businesses, and by state and local governments -- has in fact increased quite rapidly over the past few years, amounting to some 9 percent of the GNP in 1984, near the higher end of the range prevailing over the postwar period. Nevertheless, about a quarter of our net needs for investment and for deficit financing last year still had to be met from foreign sources. So far, that capital has been readily available and has played a key role in containing pressures on domestic interest rates. Even so, interest rates, as you know, have remained high both historically and relative to current levels of inflation. Without the net flow of savings from the rest of the world, pressures on our financial markets would have been still greater and interest rates would have been still higher.
Thanks to the capital inflow, the kinds of obvious "crowding out" of housing and investment so widely anticipated a year or two ago largely have been avoided. But other key sectors -- particularly those that are heavily dependent on export markets or that must compete with imports -- are being "crowded." Looking abroad, growth in many industrialized countries remains relatively sluggish and the depreciation of foreign currencies vis-a-vis the dollar seems to be one factor inhibiting the pursuit of more expansionary policies by our major trading partners, feeding back on our own export prospects. At the same time, the stability of our capital markets has become hostage to a continuing net inflow of international funds.

In this context, let me make a few observations about monetary policy. In the most general terms, the objective of the Federal Reserve is to provide sufficient money and credit to support sustainable growth in real output and employment, while moving toward greater price stability. Appreciable progress was made in these directions in 1984. We will want
to provide enough money this year to sustain orderly growth
in demand and output, and my earlier testimony reviews our
plans in that respect.

However, money creation cannot resolve an underlying
imbalance between domestic saving and investment. Real savings
release real resources for investment and for use of the govern-
ment, and growth in savings tends to work against inflation.
But beyond fostering sustainable growth, money creation cannot
release resources to meet investment and Federal needs. Rather
it adds to the demands upon those resources. Indeed, should
excessive monetary growth ignite inflationary fears, the
effort to encourage savings and reduce capital market pressures
would be undercut. As prospects for stability are undermined,
the international capital flows on which, for the time being,
we are dependent would be discouraged. And the implications
for interest rates -- probably sooner rather than later --
would be adverse. The risks of more inflation and less growth
over time would be increased, not reduced.
A number of policies -- with monetary and fiscal policies leading the list -- must be blended together to encourage sustained and balanced growth. In practice, achieving an optimum blend is seldom easy, and the precise measures to be taken can be debated. But what does seem clear now is that any satisfactory approach is dependent upon substantial cuts in our massive budgetary deficit. And, within the range of practicality, the larger and sooner the cuts the better. To have a real impact this year on markets and the economy the actions must be large enough and credible enough to have an impact on expectations and confidence, even if the measures taken will be phased in over time.

I am sensitive to the practical and political difficulties of the decisions that must be made. I realize there is no natural constituency for specific budgetary cuts or revenue measures. But I also know that we are, at present, on a course that cannot be sustained indefinitely.

The practical question is whether we act now to build on the progress of the past and reinforce prospects for future
growth and stability or whether, as so often in the past, we wait for crisis and dislocation to be a catalyst for action. But then it would be too late, and the longer constructive action is delayed, the greater the risks and the larger the task.

* * * * * * *