Statement of

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It is a pleasure to testify before this Committee here in Nashville. My subject today is the outlook for the economy and the dilemmas faced by both fiscal and monetary policymakers.

The performance of the economy has been poor this year. The annual rate of inflation has accelerated to about 13 percent from 9 percent during the previous year. The major reasons for this surge in prices are the jump in energy prices, rising costs of purchasing and financing homes, increases in beef prices, and higher import costs. In addition, some manufacturers encountered capacity limitations beginning last fall. At the same time, the economy has weakened since the end of last year. During the first three quarters of 1979, there has been virtually no growth in our gross national product (GNP), after adjusting for inflation.

CBO's most recent forecast, prepared in July when the Budget Committees were beginning work on the second budget resolution for fiscal year 1980, anticipated a mild recession, combined with a continuation of high rates of inflation:

- Real GNP was projected to decline about 1 percent;
- The unemployment rate was forecast to average 7 1/4 percent next year; and
- Consumer price inflation was expected to moderate somewhat, although remaining at a high rate of about 9 percent next year.

Although we have not prepared a new forecast, recent events have not made us more optimistic. Indeed, it now appears that it may take even longer to slow inflation and that the recession may well be deeper than we anticipated.

Three recent developments are of particular significance in assessing the economic outlook:

- o Real disposable income has continued to fall since the first quarter of the year;
- o The savings rate fell to an exceptionally--and probably unsustainably--low rate in the third quarter; and
- o Most important, inflation has continued unabated--rising at an extraordinary annual rate of more than 13 percent so far this year, leading to significant policy responses by the Congress and the Federal Reserve.

The Congressional Response

The Congress was faced with the difficult question of how much to tighten the budget in response to high inflation and a weakening economy. After careful deliberations, the House-Senate conference decided to hold the deficit below $30 billion for fiscal year 1980. This was very difficult to do because of the projected weakening of the economy next year, increased sentiment for higher defense spending, and considerable support for a sizable tax cut. The conference agreement required both a decline in real spending for the controllable categories of nondefense expenditures and a foregoing of tax cuts.

Federal Reserve Policy

The current economic situation has also placed the Federal Reserve in a difficult position. The rapid inflation has been associated with an acceleration of growth in the money supply and has made the dollar more vulnerable to speculation in international currency markets.

In response to these circumstances, the Federal Reserve sharply tightened credit conditions last month. It took three separate actions. First, the discount rate--the interest rate the Federal Reserve charges its member banks--was raised a full percentage point to 12 percent. Second, bank reserve requirements were imposed on some sources of purchased funds--such as those from the Eurodollar market. This move effectively increases the cost to banks of making loans and should dampen somewhat their willingness to expand credit. Third, and perhaps most important, the Fed announced a change in its operating procedure. It now intends to manage more rigidly the supply of money and credit in the economy by controlling nonborrowed bank reserves, rather than focusing on the federal funds rate.

The upshot of this change in operating procedure, if actually adhered to, is at least twofold. On the plus side, it may allow the Fed to coordinate changes in credit conditions more closely with the business cycle. Under the old procedure, when interest rate stability was an independent goal, credit tended to remain too easy as inflation resulting from excess demand built up toward the end of boom periods, and monetary policy--after becoming restrictive--typically remained too tight as the economy fell into recessions.

On the more negative side, as policy focuses on controlling money growth, interest rates--particularly short-term rates--could become quite volatile. The prospect of highly uncertain, rapidly moving interest rates is understandably disquieting to individuals and to financial-market participants.

And interest rates did react sharply to the Fed moves of last month. The federal funds rate has gyrated as high as 18 percent in recent weeks, and the bankers' prime rate jumped from 13 1/2 to 15 1/4 percent. Mortgage and bond rates also have increased substantially. The Fed recognizes that high rates cause many hardships, but feels compelled to reduce money growth in order to slow inflation and defend the international value of the dollar.

How Tight Money Works

Restrictive monetary policy can be effective in reducing inflation by reducing spending. The depressing effect of tighter credit on economic activity works largely through five channels:

- Residential construction. The high cost of borrowed money will reduce loans to support construction activity--especially speculative home building--and will reduce the number of families who can qualify for mortgages.

- Durable goods consumption. To some degree, tight credit will slow borrowing to finance "big ticket" consumer purchases, such as automobiles.

- Business investment in plant and equipment. Projects may be postponed or stretched out as financial officers of large firms attempt to avoid paying peak rates and as small firms see their lines of credit drying up.

- State and local construction. Again, projects may be postponed or stretched out as government units attempt to avoid peak rates.

- Inventories. Business stocks are purchased with borrowed money. As they become more expensive to finance, inventories may be reduced, depressing manufacturing orders and production. We have, for example, reports of auto dealers cutting back their inventories for this reason.

Restrictive policies operating through these channels can reduce spending and pressures on prices. Reducing economic activity does not, however, immediately reduce inflation. Once started, inflation builds up considerable momentum, as some incomes adjust in order to catch up to previous inflation.

The Problems with Tight Money

The use of monetary policy to fight inflation creates a number of problems. Initially, tight monetary policy causes higher inflation because higher interest rates increase costs. The cost of money directly enters the Consumer Price Index in two ways: mortgage interest costs and automobile financing charges. Both have contributed to the surge of prices this year. Even more important than these direct influences, higher interest rates indirectly place strong upward pressures on prices as businesses attempt to pass along these higher costs to their customers. Eventually, tight money does reduce inflation by slowing spending and output.

A more serious drawback of restrictive monetary policy is the necessity for a substantial amount of slack for a prolonged period to slow inflation that has built up rapid momentum. Large econometric models fit over the postwar period suggest that, on average, it takes one additional percentage point of unemployment for one year--or roughly $50 billion in lost production--to reduce inflation 0.3 percentage point. If this degree of economic slack is maintained for

three years, it is estimated to lower inflation by between 0.6 and 1.8 percentage points. While economists may argue over the precise magnitudes, clearly the cost of this anti-inflation medicine is great.

Of course, great uncertainty surrounds such estimates, and this fact leads to another problem. The Federal Reserve (and the Congress) cannot be sure that their actions to slow inflation will not have a greater depressing effect on output and employment than they intend. This is a serious risk associated with restrictive policies.

Finally, the costs of tight policies are not evenly shared throughout the economy. A disproportionate burden is placed on a few groups, such as young families who find themselves priced out of home ownership and small businesses threatened by the high costs of financing inventories and the drying up of lines of credit. In addition, tight credit places a penalty on investment activities of all kinds, with the consequent adverse effect on future productivity growth.

Efficient Anti-Inflation Policy

What can be learned from the dilemma faced by economic policymakers? One thing is clear. This is not an easy time to sit on the Federal Reserve's Open Market Committee or on the Congressional Budget Committees. The choices available are not good. There is simply no magic setting on the monetary or fiscal dials that offers us an easy way out of our current difficulties.

That is a discouraging conclusion, but it contains an important message about the design of economic policies. The use of monetary

and fiscal policies alone to restrain rapid inflation is too limited an approach. We surely can do more to restrain price increases than just reduce production and employment. Indeed, a good battle plan would be to supplement responsible macroeconomic policies with every workable anti-inflation action we can think of, including the following:

- Modification of government actions that raise costs and prices--such as import limitations, minimum wages, farm price supports, transportation regulation, federal excise taxes, state sales taxes, payroll taxes, and the like;
- Promotion of productivity growth--through tax incentives for business fixed investment, direct investment in human capital, dissemination of information on efficient technologies and workplace organization as well as labor- and product-market opportunities; and
- Encouragement of responsible wage-price behavior in the private sector--for example, to keep OPEC price rises out of the industrial wage structure.

Conclusion

These anti-inflation actions will not be easily undertaken. The problem is the nature of inflation itself. To a significant degree, our recent experiences with rapid inflation have reflected a contest over income shares in the economy. There have been winners and losers in this battle. The winners have often used market power--either their own or the government's--to resist any reduction in their traditional growth of real income. The losers have been able to influence their incomes directly and have fallen progressively behind.

Most anti-inflation policies will also have winners and losers. The losers from tight monetary policy, for example, are those squeezed out of credit markets and, most important, those who lose their jobs.

There is no easy anti-inflation program that the Congress, the Federal Reserve, or anybody else can pull out of its hat. Inflation can be slowed, but not without costs. In the present circumstances, perhaps the best we can do is to see that the burden of adjustment to a non-inflationary economy is equitably shared.