

Statement  
U.S. Senate Committee on the Budget  
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Economic policies do not work instantly. Reductions in the growth of government spending that shift resources to more efficient uses do not immediately trigger equal or greater increases in private spending. Tax cuts that encourage saving and effort do not generate instant responses. Reductions of money growth do not instantly reduce inflation. All of these policies have their expected effects only if people believe the policies will remain in effect.

For many years, this Committee advocated policies similar to those that have now been adopted. We said that, if the policies were maintained in place, sustained higher productivity growth, increased employment and lower inflation would follow within two years. We emphasized that a more rapid response could be achieved if the policies are credible and commitment to the policies is sustained through the difficult months following their adoption.

The policies we advocated are now in place. Currently, the most reliable indicators of money growth are substantially below their past peak rates of increase. The growth of government spending is slower, and tax rates are lower.

A widespread belief persists that the administration and the Federal Reserve will not sustain these policies. Projected growth rates of defense spending, social security outlays and medicare costs appear to many observers to be incompatible with the projected real growth of the economy at lower rates of inflation. The conflict between the budget and the economic forecasts has stimulated daily discussion about the prospects of a budget deficit instead of a small surplus in 1984 amid rising cries of failure.

Intense concentration on a particular value of the budget surplus or deficit for 1984 misplaces attention. We wrote in our March statement:

"Doubts about the size of the deficit will not be removed even if Congress approves the entire program. The administration's forecast of the growth of nominal income for 1982-86 appears to us inconsistent with its assumptions about monetary and fiscal policies and the historical record of performance of the American economy. The estimates of real growth are more optimistic and estimates of the slowing of inflation more pessimistic than we believe the administration's policies will achieve."

There is a growing conflict between the policies pursued and the forecasts of their effects. The problem is that presently no one knows which course the administration will follow. They can choose to realize their budget forecasts for 1983 and 1984 by inflating the economy in line with their forecasts of nominal income growth. Or, they can continue present policies and accept the results – a larger budget deficit in fiscal 1982 and later years. The conflict heightens current uncertainty and sustains those who believe that the lower rates of inflation we now observe are a temporary pause in the long uptrend.

### Three Options

The administration has three options. One is to maintain their current forecasts. These forecasts project the average growth of nominal and real GNP at 12% and 4.5% respectively for the next three years. The forecast of real growth is well above the historical average achieved by the U.S. economy and the projected nominal growth is inconsistent with continued and sustained decline in the rate of inflation. The projected rate of nominal income growth cannot be achieved with the monetary policies that the President, leading member of his administration – and we – urged the Federal Reserve to follow. The forecasts fail to recognize the considerable progress toward lower inflation that has been achieved this year.

Second, the administration can alter its forecast while reaffirming its commitment to the monetary and fiscal policies that are now in place. This choice accepts the fact that real growth is likely to be slower, and inflation lower, than previously projected. Consequently, budget deficits in future years will be higher than current administration forecasts. By choosing this option, the administration enhances the credibility of current policy and reduces uncertainty about future policy.

Third, the administration can adjust budget and regulatory policies to achieve higher real growth while reaffirming its commitment to the Federal Reserve's announced policies of sustained, gradual reduction of money growth. This option, like the second, discards the administration's February and July forecasts and thereby reduces uncertainty about the administration's intentions. In addition, this option recognizes that a substantial reduction in the measured rate of inflation has been made. The reduction in inflation lowers the growth of GNP and increases the deficit. A larger deficit achieved by reducing inflation should not be scorned. On the contrary, targets for money growth should be lowered to sustain and increase progress against inflation.

We prefer option 3. We call on the administration to reaffirm announced budget and

monetary policies, to make further reductions in spending and to revise its current forecast. This option is most desirable if additional reductions in spending are made to enhance efficiency not solely for the purpose of achieving a particular value for the budget surplus or deficit on a given date. We believe that more efficient use of resources, including resources devoted to defense, can be achieved by shifting resources from public to private hands.

### Budget Policy

The administration has made substantial progress toward a more rational fiscal policy by reducing the growth of government spending and by reducing tax rates. The reductions were offered as first steps toward a long-term solution of neglected economic problems. Yet, within a few weeks of Congressional passage of the budget resolution, and before the program takes effect, it is frequently and incorrectly described as a failure.

The administration should not allow current, excessive emphasis on the size of the deficit, temporary changes in stock prices or forecasts of the future deficit to dominate current concerns or obscure the goals of economic policy. A balanced budget in 1984 is not a goal of policy – and should not be made a goal of policy. A balanced budget should be achieved in 1984 only, if at all, by following policies that lead to accepted goals of more employment, less inflation, higher productivity growth and greater freedom and efficiency.

Budget reductions should be made in any category of spending that permits the administration's (defense and non-defense) programs to be achieved in ways that are consistent with these long-term goals. The administration's July projections show an increase of \$118 billion in defense outlays, a rise of 17% a year from 1980 to 1984. It seems likely that a more efficient use of resources can be achieved at a slower rate of increase.

The administration should make clear that a budget deficit resulting from slower inflation is preferred to a budget that is balanced by high or rising inflation. The recent experience of Japan shows that deficits do not prevent the central bank from controlling money growth and reducing inflation but reduced inflation prevents the deficit from falling as a percentage of GNP. In Japan, deficits as a fraction of GNP are about twice U.S. deficits. Nevertheless, money growth has been lowered from more than 12% in 1978 to minus 2% in 1980. Inflation has been reduced as the economy expanded.

## Monetary Policy

The Federal Reserve repeats frequently, that it is committed to sustained gradual reductions of money growth, the policies we have advocated. In its recent statement, the Federal Open Market Committee (FOMC) indicated a preference for growth of  $M_{1B}$  - currency and checkable deposits - in the range of 6 to 7% from 4th quarter 1980 to 4th quarter 1981 and a further reduction to the range of 2 1/2 to 5 1/2% in the following four quarters. These targets permit  $M_{1B}$  to reach an average of \$445 billion in the fourth quarter of 1981 and make \$463 billion the mid-point of the range reached by 4th quarter 1982.

The FOMC's proposed rate of monetary growth for the remaining months of 1981 is faster than would be permitted by the course we have proposed - six percent growth in the monetary base, as reported by the Federal Reserve Bank of St. Louis, from 4th quarter 1980 to 4th quarter 1981. We urge the Federal Reserve to keep money growth consistent with our target this year and to lower the growth rate of the monetary base to 4 1/2% in 1982. Our targets bring the average level of the monetary base to \$172 billion in 4th quarter 1981 and \$181 billion in fourth quarter 1982.

## Progress Against Inflation

Our proposal for 4 1/2% growth in the monetary base for 1982 recognizes that greater progress has been made toward price stability than we, or others, anticipated six months ago. The lower than anticipated rate of inflation reported for 1981 means that growth of nominal GNP is lower than anticipated because inflation is lower.

Slower inflation in 1981 is partly a result of chance events and partly a response to firmer and better policies. Decontrol of oil prices, the decision to allow the exchange rate to appreciate without intervention, favorable harvests, and many other factors helped to lower the measured rate of inflation this year. These gains must not be thrown away.

The cost of ending inflation can be reduced dramatically if the public becomes convinced that inflation has fallen and will continue to fall. Anticipation of slower inflation means that real wage demands can be achieved with smaller increases in current wages. So far this year, the rate of increase of hourly earnings has fallen from 11%, in late 1980, to 7%. Other measures of wage changes show similar, or greater, reductions in rates of increase. Simultaneous reductions in rates of change of wages, other costs and prices lower the costs we pay to reduce inflation.

The unemployment rate is now lower than at the start of the year, and a larger fraction of the population is employed. Considerable progress has been made toward lower inflation. To date, the costs of disinflation have been much lower than anyone anticipated.

We cannot costlessly end fifteen years of inflation and low productivity growth. What is needed now is a strong commitment to continue and strengthen the policies to which the administration is committed. We should not back away from policies that are working better than we anticipated.