

Statement by
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before the
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and Urban Affairs
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Mr. Chairman, and members of the Committee, I appreciate this opportunity to review with you recent and prospective monetary policy and the economic outlook. I would also like to provide a broader perspective by discussing in some detail our nation's longer-term economic objectives, the overall strategy for fiscal and monetary policies needed to reach those objectives, and the appropriate tactics for implementing monetary policy within that strategic framework.

The economic setting and monetary policy so far in 1988.

The macroeconomic setting for monetary policy has changed in some notable respects since I testified last February. At that time, the full after-effects of the stock market plunge on spending and financial markets were still unclear. While most Federal Open Market Committee members were forecasting moderate growth, in view of rapid inventory building and some signs of a weakening of labor demand, the possibility of a decline in economic activity could not be ruled out. To guard against this outcome, in the context of a firmer dollar on exchange markets, the Federal Reserve undertook a further modest easing of reserve pressures in late January, which augmented the more substantial easing following October 19. Short-term interest rates came down another notch, and with a delay helped to push the monetary aggregates higher within their targeted annual ranges.

In the event, the economy proved remarkably resilient to the loss of stock market wealth. Economic growth remained vigorous through the first half of the year. Continuing brisk advances in exports, together with moderating growth in imports, supported expansion in output, especially in manufacturing. Some strengthening also was evident in business outlays for equipment, especially computers, and consumer purchases of durables, including autos.

Financial markets also returned to more normal functioning. Although trading volumes did not regain pre-crash levels in many markets, price volatility diminished somewhat and quality differentials stayed considerably narrower than in the immediate aftermath of the stock market plunge. In response, the Federal Reserve gradually was able to restore its standard procedure of gearing open market operations to the intended pressure on reserve positions of depository institutions. We thereby discontinued the procedure of reacting primarily to day-to-day variations in money market interest rates that had been adopted right after the stock market break.

As the risks of faltering economic expansion and further financial market disruptions diminished, the dangers of intensified inflationary pressures reemerged. Utilization of labor and capital reached the highest levels in many years, and hints of acceleration began to crop up in wage and price data. Strong gains in payroll employment that continued through the spring combined with slower growth in the labor force to lower

the unemployment rate by about 1/4 percentage point, even before the strong labor market report for June; the industrial capacity utilization rate moved up as well. In part reflecting the payroll tax increase, broad measures of hourly compensation picked up somewhat in the first quarter. Prices for a wide range of domestic and imported industrial materials and supplies rose even more steeply than last year. Finished goods price inflation has not reflected this step-up in price increases for intermediate goods, in part as productivity gains kept unit labor costs under control. Even so, continued increases in materials prices at the recent pace were seen as pointing to a potential intensification in inflation more generally, since based on historical experience, such increases have tended to show through to finished good prices.

In these circumstances, the Federal Reserve was well aware that it should not fall behind in establishing enough monetary restraint to effectively resist these inflationary tendencies. The System took a succession of restraining steps from late March through late June. The shortest-term interest rates gradually rose to levels now around highs reached last fall. Responding as well to the unwinding of a tax-related buildup in liquid balances, M2 and M3 growth slowed noticeably after April.

In contrast to the shortest-maturity interest rates, long-term bond and mortgage rates, though also above February lows, still remain well below last fall's peaks. The timely

tightening of monetary policy this spring, along with perceptions of better prospects for the dollar in foreign exchange markets in light of the narrowing in our trade deficit, seemed to improve market confidence that inflationary excesses would be avoided. Both bond prices and the dollar rallied in June despite increases in interest rates in several major foreign countries and jumps in some agricultural prices resulting from the drought in important growing areas.

The economic outlook and monetary policy through 1989.

The monetary actions of the first half of the year were undertaken so that economic expansion could be maintained, recognizing that to do so, additional price pressures could not be permitted to build and progress toward external balance had to be sustained. The projections of FOMC members and nonvoting presidents indicate that they do expect economic growth to continue, and inflation to be contained.

The 2-3/4 to 3 percent central tendency of FOMC members' expectations for real GNP growth over the four quarters of this year implies a deceleration over the rest of the year to a pace more in line with their expected 2 to 2-1/2 percent real growth over 1989 and with the long-run potential of the economy. The drought will reduce farm output for a time, and it is important that nonfarm inventory accumulation slow before long, if we are to avoid a troublesome imbalance. Still, further gains in our international trade position should continue to provide a major stimulus to real GNP growth through next year,

reflecting the lagged effects of the decline in the exchange value of the dollar through the end of last year. Although the month-to-month pattern in our trade deficit can be expected to be erratic, the improvement in the external sector on balance over time is expected to replace much of the reduced expansion in domestic final demands from our consumer, business, and government sectors.

Employment growth is anticipated to be substantial, though some updrift in the unemployment rate may occur over the next year and a half. Capacity utilization could well top out soon, as growth in demands for manufactured goods slows to match that of capacity.

Considering the already limited slack in available labor and capital resources, a leveling of the unemployment and capacity utilization rates is essential if more intense inflationary pressures are to be avoided in the period ahead. Otherwise, aggregate demand would continue growing at an unsustainable pace and would soon begin to create a destabilizing inflationary climate. Supply conditions for materials and labor would tighten further and costs would start to rise more rapidly; businesses would attempt to recoup profit margins with further price hikes on final goods and services. These faster price rises would, in turn, foster an inflationary psychology, cut into workers' real purchasing power, and prompt an attempted further catchup of wages, setting in motion a dynamic process in

which neither workers nor businesses would benefit. The hard-won gains in our international competitiveness would be eroded, with feedback effects depressing the exchange value of the dollar. Excessive domestic demands and inflation pressures in this country, with its sizable external deficit, would be disruptive to the ongoing international adjustment of trade and payments imbalances.

Not only the reduced slack in the economy but also several prospective adjustments in relative prices have accentuated inflation dangers. One is the upward movement of import prices relative to domestic prices, which is a necessary part of the process of adjustment to large imbalances in international trade and payments. Another is the recent drought-related increases in grain and soybean prices. It is essential that we keep these processes confined to a one-time adjustment in the level of prices and not let them spill over to a sustained higher rate of increase in wages and prices. Elevated import and farm prices must be prevented from engendering expectations of higher general inflation, with feedback effects on labor costs. A more serious long-run threat to price stability could come from government actions that introduced structural rigidities and increased costs of production. Protectionist legislation, inordinate hikes in the minimum wage, and other mandated programs that would impose costs on U S producers would adversely affect their efficiency and international competitiveness.

The costs to our economy and society of allowing a more intense inflationary process to become entrenched are serious. As the experience in the past two decades has clearly shown, accelerating wages and prices would have to be countered later by quite restrictive policies, with unavoidably adverse implications for production and employment. The financial health of many individual and business debtors, as well as of some of their creditors, then would be threatened. The long-run costs of a return to higher inflation and the risks of this occurring under current circumstances are sufficiently great, that Federal Reserve policy at this juncture might be well advised to err more on the side of restrictiveness rather than of stimulus.

We believe that monetary policy actions to date, together with the fiscal restraint embodied in last fall's agreement between the Congress and the administration, have set the stage for containing inflation through next year. The central tendency of FOMC members' expectations for inflation in the GNP deflator ranges from 3 to 3-3/4 percent over this year and 3 to 4-1/2 percent next year. But in one sense the GNP deflator understates this year's rate of inflation, and the comparison with next year overstates the pick-up. The deflator represents the average price of final goods and services produced in the United States, or equivalently domestic value added, using current quantity weights. This measure was artificially held down in the first quarter by a shift in the composition of output, especially by the surge in sales of computers whose

prices have dropped sharply since the 1982 base year used for constructing the deflator. Indeed, if the deflator were indexed with a 1987 base year, it would have risen appreciably faster in the first quarter.

Another understatement of inflation in the deflator this year arises from its exclusion of imported goods, which are not directly encompassed because they are produced abroad. In part because import prices have continued to rise significantly faster than prices of domestically produced goods, consumer price indexes have increased more than the GNP deflator.

The FOMC believes that efforts to contain inflation pressures and sustain the economic expansion would be fostered by growth of the monetary aggregates over 1988 well within their reaffirmed 4 to 8 percent annual ranges, followed by some slowing in money growth over the course of next year. M2 should move close to the midpoint of its range by late 1988, if depositors react as expected to the greater attractiveness of market instruments compared with liquid money balances that was brought about by recent increases in short-term market rates relative to deposit rates. M3 could end the year somewhat above its midpoint, though comfortably within its range, if depository institutions retain their recent share of overall credit expansion. The debt of nonfinancial sectors, which so far this year has been near the midpoint of its reaffirmed 7 to 11 percent monitoring range, is anticipated to post similar growth through year-end.

For 1989, the FOMC has underscored its intention to encourage progress toward price stability over time by lowering its tentative ranges for money and debt. We have preliminarily reduced the growth range for M2 by 1 full percentage point, to 3 to 7 percent; last February, the FOMC also had reduced the midpoint of the 1988 range for M2 by 1 percentage point from that for 1987. We have adjusted the tentative 1989 range for M3 downward by 1/2 percentage point, to 3-1/2 to 7-1/2 percent. This configuration is consistent with the observed tendency for M3 velocity over time to fall relative to the velocity of M2; over the last decade, the Federal Reserve's ranges frequently allowed for faster growth of M3 than of M2. The monitoring range for domestic nonfinancial debt for 1989 also has been lowered 1/2 percentage point to a tentative 6-1/2 to 10-1/2 percent.

The specific ranges chosen for 1989 are, as usual, provisional, and the FOMC will review them carefully next February, in light of intervening developments. Anticipating today how the outlook for the economy in 1989 will appear next February is difficult, and a major reassessment of that outlook would have implications for appropriate money growth ranges for that year. Unexpectedly strong or weak economic expansion or inflation pressures over the next six months also could have implications for the behavior of interest rates and their prospects for 1989. The sensitivity of the monetary aggregates to movements in market interest rates means that the appropriate growth next year

in M2, M3, and debt could seem different next February than now, necessitating a revision in the annual growth ranges. As the aggregates have become more responsive to interest rate changes in the 1980s, judgments about possible ranges for the next year necessarily have become even more tentative and subject to revision.

The persistent U.S. external and fiscal imbalances.

Despite the changes in the economic setting over the last six months, other features of the macroeconomic landscape remain much the same. Most notable are the continuing massive deficits in our external payments and internal fiscal accounts. As a nation, we still are living well beyond our means; we consume much more of the world's goods and services each year than we produce. Our current account deficit indicates how much more deeply in debt to the rest of the world we are sliding each year.

The consequence of this external imbalance will be a steady expansion in our external debt burden in the years ahead. No household or business can expect to have an inexhaustible credit line with borrowing terms that stay the same as its debt mounts relative to its wealth and income. Nor can we as a nation expect our foreign indebtedness to grow indefinitely relative to our servicing capacity without additional inducements to foreigners to acquire dollar assets--either higher real interest returns, or a cheaper real foreign exchange value for dollar assets, or both. To be sure, such changes in market

incentives would have self-correcting effects over time in reducing the imbalance between our domestic spending and income. Higher real interest rates would curtail domestic investment and other spending. A lower real value of the dollar would make U.S. goods and services relatively less expensive to both U.S. and foreign residents, damping our spending on imports out of U.S. income and boosting our exports.

But simply sitting back and allowing such a self-correction to take place is not a workable policy alternative. Trying to follow such a course could have severe drawbacks now that our economy is operating close to effective capacity and potential inflationary pressures are on the horizon. The time is hardly propitious to discourage investment in needed plant and equipment, to add further impulses for import price hikes on top of the upward tendencies already in the making, or to push our export industries as well as import-competing industries to their capacity limits.

Fortunately, we have a better choice for righting the imbalance between domestic spending and income--one over which we have direct control. That is to resume reducing substantially the still massive federal budget deficit, which remains the most important source of dissaving in our economy. The fall in the dollar we have already experienced over the last few years, even allowing for the dollar's appreciation from the lows reached at the end of last year, has set in motion forces that should continue to narrow our trade and current account deficits

in the years ahead. The associated loss of foreign-funded domestic investment is likely to adversely affect overall investment unless it can be replaced by greater domestic investment financed by domestic saving. A sharp contraction in the federal deficit appears to be the only assured source of augmented domestic net saving. Such a fiscal cutback should help counter future tendencies for further increases in U.S. interest rates and declines in the dollar, partly by instilling confidence on the part of international investors in the resolve of the United States to address its economic problems.

Fiscal restraint in the years ahead would assist in making room for the needed diversion of more of our productive resources to meeting demands from abroad. Domestic demands will have to continue growing more slowly than our productive capacity, as seems to have been the case so far this year, if net exports are to expand further without resulting in an inflationary overheating of the economy. Absent this fiscal restraint, higher interest rates would become the only channel for damping domestic demands if they were becoming excessive. If a renewed decline in the dollar were adding further inflationary stimulus at the same time, upward pressures on interest rates would be even more likely. The restrictive impact would be felt most by the interest-sensitive sectors--homebuilding, business fixed investment, and consumer durables

In terms of federal deficit reduction, the schedule under the Gramm-Rudman-Hollings law is a good baseline for a

multi-year strategy, and I trust the Congress will stick with it. But we should go further. Ideally, we should be aiming ultimately at a federal budget surplus, so that government saving could supplement private domestic saving in financing additional domestic investment. Historically, the United States was not a low saving, low investing economy. From the post-Civil War period through the 1920s, the United States consistently saved more as a fraction of GNP than Japan and Germany, and we saved much more as a share of GNP than we have since the end of World War II. A turnaround in our current domestic saving performance is essential to a smooth reduction in our dependence on foreign saving, and the federal government should take the lead.

It is also apparent that redressing our external imbalances must encompass cooperative policies with our trading partners. These include both the established industrial powers, the newly industrialized economies, and the developing countries, whose debt problems must be worked through as part of the international adjustment process.

This is the strategy that U.S. fiscal policy as well as economic policies abroad should follow in most effectively promoting our shared economic objectives. The strategic role of U.S. monetary policy is implied by a clear statement of what those ultimate objectives are. We should not be satisfied unless the U.S. economy is operating at high employment with a sustainable external position and above all stable prices.

High employment is consistent with steadily rising nominal wages and real wages growing in line with productivity gains. Some frictional unemployment will exist in a dynamic labor market, reflecting the process of matching available workers with available jobs. But every effort should be made to minimize both impediments that contribute to structural unemployment and deviations of real economic growth from the economy's potential that cause cyclical unemployment.

By a sustainable external position, I am referring to a situation in which our foreign indebtedness is not persistently growing faster than our capacity to service it out of national income. Our international payments need not be in exact balance from one year to the next, and the exchange value of the dollar need not be perfectly stable, but wide swings in the dollar, and boom and bust cycles in our export and import-competing industries, should be avoided.

By price stability, I mean a situation in which households and businesses in making their saving and investment decisions can safely ignore the possibility of sustained, generalized price increases or decreases. Prices of individual goods and services, of course, would still vary to equilibrate the various markets in our complex national and world economy, and particular price indexes could still show transitory movements. A small persistent rise in some of the indexes would be tolerable, given the inadequate adjustment for trends in quality improvement and the tendency for spending to shift toward goods

that have become relatively cheap. But essentially the average of all prices would exhibit no trend over time. Price movements in these circumstances would reflect relative scarcities of goods, and private decision-makers could focus their concerns on adjusting production and consumption patterns appropriately to changing individual prices, without being misled by generalized inflationary or deflationary price movements.

The strategy for monetary policy needs to be centered on making further progress toward and ultimately reaching stable prices. Price stability is a prerequisite for achieving the maximum economic expansion consistent with a sustainable external balance at high employment. Price stability reduces uncertainty and risk in a critical area of economic decision-making by households and businesses. In the process of fostering price stability, monetary policy also would have to bear much of the burden for countering any pronounced cyclical instability in the economy, especially if fiscal policy is following a program for multi-year reductions in the federal budget deficit. While recognizing the self-correcting nature of some macroeconomic disturbances, monetary policy does have a role to play over time in guiding aggregate demand into line with the economy's potential to produce. This may involve providing a counterweight to major, sustained cyclical tendencies in private spending, though we can not be overconfident in our ability to identify such tendencies and to determine exactly the appropriate policy response. In this

regard, it seems worthwhile for me to offer some thoughts on the approach the Federal Reserve should take in implementing this longer-term strategy for monetary policy.

The appropriate tactics for monetary policy.

For better or worse, our economy is enormously complex, the relationships among macroeconomic variables are imperfectly understood, and as a consequence economic forecasting is an uncertain endeavor. Nonetheless, the forecasting exercise can aid policymaking by helping to refine the boundaries of the likely economic consequences of our policy stance. But forecasts will often go astray to a greater or lesser degree and monetary policy has to remain flexible to respond to unexpected developments.

A perfectly flexible monetary policy, however, without any guideposts to steer by, can risk losing sight of the ultimate goal of price stability. In this connection, the requirement under the Humphrey-Hawkins Act for the Federal Reserve to announce its objectives and plans for growth of money and credit aggregates is a very useful device for calibrating prospective monetary policy. The announcement of ranges for the monetary aggregates represents a way for the Federal Reserve to communicate its policy intentions to the Congress and the public. And the undisputed long-run relation between money growth and inflation means that trend growth rates in the monetary aggregates provide useful checks on the thrust of monetary policy over time. It is clear to all observers that

the monetary ranges will have to be brought down further in the future if price stability is to be achieved and then maintained.

But, in a shorter-run countercyclical context, monetary aggregates have drawbacks as rigid guides to monetary policy implementation. As I discussed in some detail in my February testimony, financial innovation and deregulation in the 1980s have altered the structure of deposits, lessened the predictability of the demands for the aggregates, and made the velocities of M1 and probably M2 over periods of a year or so more sensitive to movements in market interest rates. Movements in short-term market rates relative to sluggishly adjusting deposit rates can result in large percentage changes in the opportunity costs of holding liquid monetary assets. Depositor responses can induce divergent growth between money and nominal GNP for a time. I might add that it was partly these considerations that led the FOMC to retain the wider four percentage point ranges for money and credit growth for this year and next.

Nonetheless, the demonstrated long-run connection of money and prices overshadows the problems of interpreting shorter-run swings in money growth. I certainly don't want to leave the impression that the aggregates have little utility in implementing monetary policy. They have an important role, and it is quite possible that their importance will grow in the years ahead. Currently, the FOMC keeps M2 and M3 under careful scrutiny, and judges their actual movements relative to assessments of their appropriate growth at any particular time.

In this context, these aggregates are among the indicators influencing adjustments to the stance of policy, both at regular FOMC meetings and between meetings, as the FOMC's directive to the Federal Reserve Bank of New York's Trading Desk indicates. The FOMC also regularly monitors a variety of other monetary aggregates. At times in recent years, we have intensively examined the properties of several alternative measures, and reported the results to the Congress. These measures have included M1, M1-A (M1 less NOW accounts), monetary indexes, and most recently the monetary base.

An analysis of the monetary base appears as an appendix to the Board's Humphrey-Hawkins report. This aggregate, essentially the sum of currency and reserves, did not escape the sharp velocity declines of other money measures earlier in the 1980s. Its velocity behavior stemmed from relatively strong growth in transactions deposits compared with GNP, which was mirrored in the reserve component of the base. In this sense, some of the problems plaguing M1 also have shown through to the base, though in somewhat muted form. Moreover, the three-quarters share of currency in the base raises some question about the reliability of its link to spending. The high level of currency holdings--\$825 per man, woman and child living in the United States--suggests that vast, indeterminate amounts of U.S. currency circulate or are hoarded beyond our borders. Indeed, over the last year and one half, currency has grown

noticeably faster than would have been expected from its historical relationships with U.S. spending and interest rates.

Although the monetary base has exhibited some useful properties over the last three decades as a whole, the FOMC's view is that its behavior has not consistently added to the information provided by the broader aggregates, M2 and M3. The Committee accordingly has decided not to establish a range for this aggregate, although it has requested staff to intensify research into the ability of various monetary measures to indicate long-run price trends.

Because the Federal Reserve cannot reliably take its cue for shorter-run operations solely from the signals being given by any or all of the monetary aggregates, we have little alternative but to interpret the behavior of a variety of economic and financial indicators. They can suggest the likely future course of the economy given the current stance of monetary policy.

Judgments about the balance of various risks to the economic outlook need to adapt over time to the shifting weight of incoming evidence; this point is well exemplified so far this year, as noted earlier. The Federal Reserve must be willing to adjust its instruments fairly flexibly as these judgments evolve; we must not hesitate to reverse course occasionally if warranted by new developments. To be sure, we should not overreact to every bit of new information, because the frequent observations for a variety of economic statistics are subject to

considerable transitory "noise". But we need to be willing to respond to indications of changing underlying economic trends, without losing sight of the ultimate policy objectives.

To the extent that the underlying economic trends are judged to be deviating from a path consistent with reaching the ultimate objectives, the Federal Reserve would need to make "mid-course" policy corrections. Such deviations from the appropriate direction for the economy will be inevitable, given the delayed and imperfectly predictable nature of the effects of previous policy actions. Numerous unforeseen forces not related to monetary policy will continue to buffet the economy. The limits of monetary policy in short-run stabilization need to be borne in mind. The business cycle cannot be repealed, but I believe it can be significantly damped by appropriate policy action. Price stability cannot be dictated by fiat, but governmental decision-makers can establish the conditions needed to approach this goal over the next several years.