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Testimony by

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Mr. Chairman and members of the Committee, I am pleased to be here today to present the midyear Monetary Policy Report to the Congress My prepared remarks this morning will take their cue from that Report by focusing on current economic and financial conditions, as well as on the outlook for the economy and monetary policy over the coming year and a half. These topics merit particularly close attention at the current time, when the economy appears to be poised at a cyclical turning point--moving from recession to expansion. In addition, I plan to devote some time to discussing the importance of the changes that we have been seeing in patterns of credit usage and in the flows of money and credit through the financial system There are signs of what could be significant departures from the trends prevalent in the 1980s, with potential implications for the interpretation of financial data and economic developments

Economic and Financial Developments in the First Half of 1991

At the time of our last Report in February, the economy had been declining for several months. The considerable uncertainty and higher oil prices that followed the invasion of Kuwait had depressed confidence and real incomes, discouraging spending by consumers and businesses and pulling down output and employment. However, even by February, the first seeds of an economic recovery appeared to have been sown: The initial coalition successes in the Gulf War, the reversal of much of the runup in oil prices, and the significant easing of monetary policy all pointed in the direction of a resumption of growth.

Today, there are compelling signs that the recession is behind us Although the turning point has not yet been given a precise date, a variety of cyclical indicators bottomed out by early spring, and some have moved noticeably higher in recent months Such data strongly suggest that the economy is moving into the expansion phase of the cycle Nevertheless, convincing evidence of a dynamic expansion is still rather limited, and we must remain alert to the chance that the recovery could be muted or could even falter

In recent months, there also have been promising signs of a slowing in inflation. The price figures themselves have bounced around from month to month, partly in response to the gyrations in oil prices and the partial embedding of those swings in the underlying cost structure of the economy. A bunching of price increases and excise tax hikes at the beginning of the year also boosted "core" inflation measures for a time But in their wake, an underlying softening trend has become evident, with consumer prices outside of the food and energy sectors rising quite modestly In an environment of slack demand, businesses have worked especially hard to control costs by keeping their operations as lean and productive as possible

With the threat of an oil-related inflation surge largely behind us and output evidently declining, the Federal Reserve took a series of easing steps in quick succession over the latter part of last year and into the spring. These actions, aimed at ensuring a satisfactory upturn in the economy, brought the federal funds rate more than 2 percentage points below its pre-recession level and 4 percentage points below its peak of about two years ago Other short-term interest rates dropped more or less commensurately Despite the progressive easing of monetary policy, the foreign exchange value of the dollar is up substantially since the beginning of the year, in part owing to the brightening outlook in the United States for economic recovery without added inflation. Anticipations of economic expansion also were reflected in rising stock prices and in long-term interest rates, which have changed relatively little on balance so far this year even as short-term rates have declined.

With the cumulative drop in short-term interest rates making monetary assets more attractive to the public, M2 growth picked up noticeably in the first half of 1991. Its growth probably was restrained to a degree, however, by the firmness in returns on capital market instruments. And, as had been anticipated at the beginning of the year, growth of M2 remained below what would have been predicted solely on the basis of historical relationships with interest rates and income. Money growth also continued to be held down by the ongoing restructuring of credit flows away from depository institutions. As the thrift industry has contracted and banks have remained quite cautious about expanding their balance sheets, there has been less need for depositories to issue liabilities--which constitute the vast bulk of the monetary aggregates. Currently, M2 and M3 are somewhat below the midpoints of their respective target ranges.

In the last several months, monetary policy has adopted a posture of watchful waiting as economic indicators have pointed increasingly toward recovery. With an eye to the usual lags in policy effects, this stance has been viewed as prudent to guard against the risk of adding excessive monetary stimulus to an economy that might already be solidly into recovery. Monetary policy during the first half of the year has had two jobs first, to help bring the economy out of recession and, second, to avoid setting the stage for the next recession, which would follow if we allowed inflationary imbalances to develop in the economy.

The progress against inflation that has been set in motion must not be lost. Moreover, by consolidating and building upon the gains against inflation, we come that much closer to our longer-run goal of price stability Inflation and uncertainty about inflation keep interest rates higher than they need be, distort saving and investment, and impede the ability of our economy to operate at its peak efficiency and to generate higher standards of living.

The Economic Outlook

It is this strategy that has been guiding monetary policy recently, and the effects of the strategy are reflected in the economic projections of the Federal Open Market Committee members and other Reserve Bank presidents On the whole, their outlook is for underlying inflation to continue to slacken as the economy first recovers and then expands at a moderate rate through the end of next year

For this year, while there remain--without question--frailties in the economy, economic activity appears on balance to be picking up in a fairly broad-based manner The expectation that the turnaround in output is occurring, and that it will persist, is evident in the economic projections of the FOMC members and other Reserve Bank presidents Their forecasts for real GNP growth over the four quarters of 1991 center on 1 percent or a shade below, implying growth over the remainder of this year that not only offsets the first-quarter decline in GNP, but also lifts output above its pre-recession peak by year-end

Two fundamental questions may be posed with regard to this outlook for the rest of the year. The first is an inquiry into the potential sources of strength in the recovery--those forces that will be at work to pull the economy out of recession in a lasting fashion. We see a number of factors as having set the stage for the recovery· in particular, the reversal of the spike in world oil prices and the favorable effects of that reversal on real incomes, the conclusion of the Gulf War and the consequent rebound in consumer and business confidence, and, finally, the decline in short-term interest rates following our policy easings and the narrowing of risk premiums in financial markets Against this backdrop, consumer expenditure growth seems to have turned positive again, along with real income, homebuilding has bottomed out and is providing some lift to overall growth, and orders for capital goods are pointing to a firming in demand that should be reflected in production and shipments in coming months

The strongest force behind output growth in the near term, though, probably will be the behavior of inventories. Business inventories have been drawn down aggressively in recent quarters, and, with inventories now quite lean, sales increasingly will have to be satisfied out of new production The inherent dynamics of an inventory cycle, as the drawdown ceases and eventually turns to rebuilding, likely will engender the bulk of the initial step-up in output. But there may be additional areas of demand that will impel the recovery, it is quite common at this point in the cycle for forecasts both to underestimate the strength of the recovery and to miss the forces that end up driving the expansion.

In fact, recessions typically have been followed by periods of appreciably stronger growth than that foreseen here. This raises the second question about the near-term forecasts, that is, whether they are optimistic enough. A number of considerations come to mind on that side of the issue. First, and in some sense most appealing, is the simple notion, which is lent some support by history, that relatively mild recessions beget relatively mild recoveries And this recession, assuming it came to an end in the spring, seems to have been mild Not only does it appear to have been marked by a considerably smaller contraction in real GNP and industrial production than the average postwar recession, it also was a bit shorter In at least one respect, however, this recession was close to average, and that was in job losses, as firms cut payrolls fairly aggressively Nevertheless, the unemployment rate did not rise as much or as high as was typical in the past

Arguing against a rapid rebound in the economy are several other factors as well, including the lack of impetus from some sectors that contributed in earlier cycles First, it has not been unusual to see some fiscal stimulus in the early stages of expansion in the past; this time, however, the Congress and the Administration have worked long and hard to make sure that genuine progress will be made in righting the structural imbalance in the budget, putting federal spending in real terms on a downward path Nor is fiscal stimulus likely to emerge from the state and local sector, where deepening budget problems are constraining spending. A portion of the financial distress of localities can be traced to the softness in real estate markets feeding through to property tax receipts The condition of the real estate market also is certain to restrain the pickup in construction that usually accompanies a recovery, with overbuilding in commercial real estate likely to damp activity in this area for some time to come Finally, in the consumer area, expenditures are unlikely to grow more rapidly than personal income, as households avoid reducing their saving rate further from its already low level

The expansion is seen as becoming more securely established next year, with real GNP growth strong enough to bring the unemployment rate down 1/2 percentage point or more from its current level Should the recovery unfold about as we expect, price pressures will remain muted and progress on inflation is likely The expectations of FOMC members and other Reserve Bank presidents for inflation this year are centered in the neighborhood of 3-1/2 percent, well down from the 6-1/4 percent rate of inflation experienced last year Although the slowdown this year is exaggerated by the retreat in oil prices, a clear deceleration should be evident even abstracting from energy prices That deceleration in the underlying trend is expected to continue next year, as well. However, the unwinding of the oil shock this year masks the improvement, so that the projection for the increase in overall consumer prices is about the same for 1992 as for 1991.

Ranges for Money and Debt Growth for 1991 and 1992

The FOMC viewed the near-term outlook for output and prices as generally favorable and consistent with growth of money and debt within the ranges that had been specified earlier in the year Consequently, at its meeting earlier this month, the FOMC reaffirmed the 1991 ranges for money and debt growth. In addition, it was felt that the money ranges retained enough scope for policy to be responsive, should the economy stray substantially from its expected path over the remainder of the year With M2 and M3 now well within their ranges, there remains ample room for money growth to change in the event policy needs either to ease in support of a faltering recovery or to tighten in reaction to an unexpected resurgence of inflation pressures

Unlike the monetary aggregates, our latest reading on debt of the domestic nonfinancial sectors places it right at the bottom edge of its 1991 range Its growth has been unusually low, and its position within the range is indicative both of the reduced demands for credit associated with the weak economy and of the restraint, on the part of borrowers and lenders, that has been evident in recent quarters In these circumstances, the FOMC felt that lowering the monitoring range would be inappropriate and might falsely suggest a complacency on the part of policymakers about weakness in credit growth. Instead, maintaining the debt range unchanged underlines the implication that a further slowdown in this aggregate would warrant close scrutiny.

On a provisional basis, the FOMC extended the 1991 ranges for money and debt growth to 1992, with the understanding that there will be opportunities to reevaluate the appropriateness of these ranges before they come fully into play next year. The ranges were viewed as consistent with additional progress against inflation and with sustained economic expansion Moreover, the path of no change appeared most sensible to the Committee at the current time of some uncertainty about the vigor and even the durability of the economic recovery, as well as about developments affecting the future of the thrift and banking industries

This uncertainty about the credit intermediation process is one of the factors that could possibly make movements in M2 somewhat difficult to interpret in the short run, but I would emphasize that we expect the aggregate to remain a stable guide for policy over the longer term The relationship between M2 and nominal income has been one of the more enduring in our financial system Since the founding of the Federal Reserve, nominal GNP and M2 have grown, on average, at almost precisely the same rate Presumably, this parity reflects an underlying demand for liquidity on the part of businesses and consumers that is associated with a given level of spending and wealth This demand is likely to persist, though the financial structures that supply the liquidity may change

Changing Patterns of Financial Intermediation and Debt Accumulation

Recently, patterns of financial intermediation have been changing, and there are signs that patterns of credit usage in general have been changing as well It is difficult to know which of these developments will show some permanence and which will prove ephemeral. But some of the recent changes have been striking and have affected a number of the financial variables that the Federal Reserve routinely monitors in an effort to glean information about the health of the economy, the soundness of the financial system, and the appropriateness of current monetary policy I would like to address several aspects of these recent developments in the remainder of my remarks today

First, at the most aggregate level, the ratio of domestic nonfinancial sector debt to nominal GNP, which soared in the 1980s, is beginning to show signs of flattening out. With the federal government's borrowing lifted by the effects of the recession and payments related to deposit insurance, these signs have been evident so far only in the other sectors While the changes in behavior may, in part, reflect cyclical factors at work, a longer-term trend also may be emerging. And this trend, if it develops fully, would represent a return to the pattern evident in earlier postwar decades In that case, it would be the 1980s, with their burgeoning federal deficits and massive corporate restructurings, that would appear the aberration. The deregulation, technological advances, and financial innovations that came at an accelerated pace in the 1980s lowered the cost of borrowing for many and probably raised the equilibrium ratio of debt to net worth for a wide range of economic entities A temporary surge in borrowing was implied in the course of this transition from one equilibrium to another.

A tapering-off of that surge would then be expected as the new equilibrium was approached, and this may be what we currently are witnessing The new equilibrium debt-to-income ratio may even be below the current level, implying the possibility of sluggish debt growth for some time If these sorts of adjustments were in train, the slow debt growth associated with them should not be read as implying that credit was insufficient to support satisfactory economic performance

A number of considerations point in the direction of restructuring of balance sheets The forces that appear to be restraining the demand for credit can be generally categorized as less "grossing up" of balance sheets and less substitution of debt for equity During the 1980s, there was a great deal of this "grossing up" of balance sheets, as credit financed more purchases both of physical assets and of financial assets As far as physical assets are concerned, the 1980s saw some strong spending on consumer durables and nonresidential structures, spending on physical assets, such as these, appears more often to be financed with debt than is spending on most other types of goods and services Now, with stocks of those assets already built up and with tax law changes that have made it less attractive in many cases to borrow to finance their purchase, credit demands are likely to remain relatively damped.

The high interest rates of the late 1970s and early 1980s spurred increased financial innovation and extensive deregulation, helping to bring businesses and consumers increasingly into more complex financial dealings. The state and local sector built up a large stock of financial assets, and the household sector acquired assets from the wider array of instruments available Moreover, household borrowing behavior was shaped importantly by the rising capital gains available on residential real estate over this period As house prices escalated, mortgage debt on existing homes increased, both as capital gains were realized in home sales and as unrealized gains were tapped through the use of second mortgages and, more recently, home equity lines In this process, home owners were able to redirect a portion of these capital gains toward other assets or current consumption.

Over the decade, the financial services industry grew at an extraordinary rate, in part by creating debt instruments seemingly tailored to every need and financial assets for any portfolio. While households took advantage of a number of these new instruments, the bulk of them were directed toward business Mergers and acquisitions took off, financed essentially by debt, resulting in net retirements of equity that averaged nearly $100 billion annually between 1984 and 1989

More recently, with debt levels relatively high and lenders less eager to extend credit, markets have changed One aspect of this change shows up dramatically in data for the second quarter, where equity issuance by nonfinancial corporations is estimated to have exceeded equity retirements for the first time in eight years, removing this element behind the buildup of debt While much of the weakness in credit demand at present reflects cyclical influences, borrowers likely will continue to shy away from the heavy expansion of debt seen in the 1980s

On the supply side of the credit market, perhaps the major factor at work in creating a break with the behavior of the 1980s has been the adverse consequences of that behavior It is now clear that a significant fraction of the credit extended during those years should not have been extended We need merely look at the recent string of defaults and bankruptcies, and the condition of many of our financial intermediaries to confirm this impression

In a sense, this process may have been very nearly inevitable With the financial system groping toward a new equilibrium, the likelihood of mistakes was high. Laxity by lenders abetted the spiral of debt, and we regulators were too often slow to intervene. Now, financial institutions, regulators, and taxpayers are facing the wrenching unwinding of those lending decisions. A key lesson to be learned is how important it is to avoid these costly adjustments in the future and that this can only be done by avoiding a return to such financial laxity

Going forward, we likely will see a continuation of the "credit correction" now under way One aspect of this correction is the increased attention paid by regulators and the financial markets to the capital positions of financial intermediaries The more prudent approach to capitalization and lending decisions is overwhelmingly a healthy development that ultimately will result in strengthened balance sheets for the nation's financial institutions and more assurance of stability of the financial system

In certain areas, however, the credit retrenchment appears to have gone beyond a point of sensible balance. In some cases, lender attitudes and actions have been characterized by excessive caution As a result, there doubtless are creditworthy borrowers that are unable to access credit on reasonable terms Even in the obviously troubled real estate area, new loans are arguably too scarce, in some cases intensifying the illiquidity of the market for existing properties To an extent, the scarcity of some types of loans may reflect the efforts of individual financial institutions to reduce the share of their assets in a particular category, such as commercial mortgages While a single bank may be able to do this without too much trouble, when the entire industry is trying to make the same balance sheet adjustment, it simply cannot be done without massive untoward effects. Instead, it may be in the banks' self-interest to make the adjustment in an orderly manner over time Regulatory efforts to address credit availability concerns continue

Credit conditions remain tight is some sectors, but in others the situation appears to have improved considerably since our last Report in February To chronicle briefly what we know about credit supply conditions at present· In financial markets generally, risk premiums and spreads between yields on different types of debt have declined substantially this year as investor attitudes have improved In part reflecting this narrowing, corporate bond offerings surged over the first half of the year Banking firms, too, gained increased access to capital markets, leaving them in a better position to lend as credit demands begin to pick up in the recovery Indexes of bank stock prices rose much more rapidly than the stock market as a whole, bringing the average market value of shares in the top fifty bank holding companies back up to around their book value. Yield spreads on bank-related debt obligations narrowed sharply over the first half of the year, prompting considerable issuance Thus far, however, lending by commercial banks has remained quite weak To the extent we can judge, this appears primarily to reflect weak credit demand, as is typical at this point in the business cycle Nonetheless, supply restrictions remain a problem This so-called "credit crunch" owes importantly to financial institutions' efforts to build capital to meet the demands of both the market and the regulators Information on lending terms, however, suggested little further tightening over the spring.

Not only the behavior of the debt aggregate itself, but also the avenues through which the debt flows, represent something of a break with the past The recent decline in the importance of depository institutions as intermediaries, when measured by the credit they book, is quite striking While this predominantly reflects the contraction of the thrift industry, banks, too, have contributed by growing only slowly Over time, other financial institutions have provided more close substitutes for banking services, and the profitability of the banking industry suffered over the last decade or so from a decline in loan quality Moreover, recent emphasis on higher capital ratios and higher deposit insurance premiums should affect this trend as well.

Even as the economy has firmed, financial flows through depository institutions have remained weak Some lag is typical. Indeed, in the case of business loans, there is enough of a regularity that they are included in the Department of Commerce's Index of Lagging Economic Indicators But lending to businesses has been unusually weak for some time now and the outlook is for a rather modest upturn when it comes At the same time that decisions to purchase goods and services are made, decisions about the financing of those purchases are usually being made. Increasingly, it appears that those decisions are not being reflected in credit on the books of depository institutions Banks still may be involved, however They may, for example, provide letters of credit or arrange financing through a special-purpose corporation Mortgage and consumer debt may pass through the balance sheets of these intermediaries only briefly, as it is increasingly being securitized and sold into capital markets As banks make further strides in bolstering their capital positions, however, they will become better able to take advantage of opportunities to add profitable loans to their balance sheets. While the role of the banking industry has been changing, its importance in the financial system and the economy remains assured

In sum, the financial system in this country is changing, and it is changing rapidly Technology, regulatory initiatives, and market innovations are changing many dimensions of the financial system. The relationships between borrowers and lenders, between risk and balance-sheet exposure, and between credit and money are being altered in profound ways. In response, we must understand the nature of these changes, their permanence, their limitations, and their possible implications for the economy and monetary policy And we must ensure that the stability of the financial system is protected as changes occur, for a sound financial system is an essential ingredient of an effective monetary policy and a vital economy