

For release on delivery  
9:30 a m EST  
February 24, 1993

Testimony by

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Board of Governors of the Federal Reserve System

before the

Committee on the Budget

U S House of Representatives

February 24, 1993

Mr Chairman and members of the Committee, I very much appreciate the opportunity to meet with you today, especially in view of the crucial budgetary issues now before the Congress. As you know in the last few days I have given detailed testimony on the conduct of monetary policy in 1992 and our plans for 1993. Accordingly, I shall be rather general today in discussing monetary policy, focusing instead on the economic outlook and the relationship between fiscal policy and monetary policy.

Our economy recently has made considerable progress in overcoming structural imbalances and improving the prospects for sustainable long-run growth. The Federal Reserve has contributed to this progress by easing the stance of monetary policy in a measured fashion and thus helping to encourage appreciable declines in long-term interest rates. As I will be discussing, considerable imbalances in the economy remain, and the uncertainties are sizable. But on balance, the prospects are reasonably good for continued economic growth and declines in unemployment in 1993. We at the Federal Reserve intend to continue to conduct policy in such a way as to support the economic expansion while containing inflation and making further progress toward price stability. This policy approach should help to promote sustainable long-term growth of our economy.

Fiscal policy similarly can contribute to sustainable and robust economic growth. The President's budget proposals have prompted anticipation in the markets that there will be genuine progress in the reduction of federal budget deficits. This anticipation has been the most important factor behind the very significant recent declines in intermediate- and long-term interest rates. These lower rates are a striking reminder that reducing federal deficits will free up private savings, reduce the cost of

credit to private borrowers, and encourage accumulation of capital that will help to enhance growth in the future

To provide some background for discussion of future monetary and fiscal policies, I would first like to review recent economic developments and the conduct of monetary policy. I will then turn to the economic outlook and our monetary policy plans for 1993, and conclude with some comments on fiscal policy and its relationship with monetary policy.

#### Recent Economic Developments

Our economy has experienced considerable impediments to growth in the last few years. In my view, adjustments to certain imbalances and structural changes in the economy have been important causes of the sluggish performance of the economy until recently.

As I have often noted, balance sheet adjustments have been a key element. By the late 1980s, balance sheets had been weakened appreciably by the large runup in debt over the previous seven years or so. But in addition, actual declines in asset prices--particularly in commercial real estate prices but, in many locales, in housing prices as well--unambiguously signalled a serious imbalance between demands and supplies for certain structures. These declines, in turn, represented a significant reduction in the wealth of many firms and households. These entities, and many others who experienced difficulties servicing debt, typically responded by restraining expenditures on real goods and services, reducing the forward momentum of the economy.

The difficulties of borrowers and declines in real estate values spilled over onto the financial institutions that financed such purchases. With loan losses mounting and under pressure from the markets and regulators to improve their capital ratios, those

institutions tightened terms and standards on many types of loans. The reduced availability of credit limited the ability of certain smaller and medium-sized firms to expand, and contributed to the weakening of the economy.

Following the invasion of Kuwait and the associated jump in oil prices and drop in confidence, a recession began. From peak to trough, real gross domestic product declined 2-1/4 percent. Total employment declined considerably, industrial production fell, and capacity utilization dropped.

Although an economic recovery began in the spring of 1991, it was rather anemic. Some of the factors that had earlier weakened the economy continued to weigh on aggregate demand, particularly efforts by businesses and households to bring down debt burdens, the reduced availability of business credit, and the hangover in the commercial real estate sector. In addition, state and local governments, faced with a recession-induced decline in revenues, retrenched. And real federal defense purchases, after peaking in 1987, have moved down considerably, depressing demand further. As a result, real GDP expanded at only a 1.6 percent average annual rate during the first five quarters of the recovery. With real GDP growth below the expansion of the economy's potential to produce, unemployment continued to rise substantially.

More recently, however, the expansion has shown somewhat more vigor. Real GDP rose at a 3-1/2 percent rate in the third quarter and is currently estimated to have increased at a 3-3/4 percent rate in the fourth quarter. And data that have become available since this estimate was prepared suggest that the fourth-quarter growth could well be revised up substantially. Halfway through the first quarter,

we appear to be growing at a somewhat slower pace than in the second half of last year

The stronger pace of economic growth has aided the employment picture somewhat. While payroll employment fluctuated over 1992, on balance it rose during the year for the first time since 1989. Nevertheless, unemployment remained a serious problem. The number of unemployed persons rose considerably in the first half of 1992, despite a moderate gain in GDP, and the unemployment rate climbed to 7-3/4 percent by midyear. Over the second half of the year, the number of unemployed persons declined appreciably, and the unemployment rate moved down to 7.3 percent. In January, the rate edged down further to 7.1 percent.

The modest gains in employment and the continuing high unemployment rate reflect, in part, determined efforts by firms to limit costs and boost productivity in an environment of intense domestic and foreign competition. Many firms have taken measures to boost profitability by shrinking their workforces, closing down unprofitable units, and employing recent advances in computing and communications technology more effectively. As a result, labor productivity has shown remarkable gains recently. For example, output per hour in the nonfarm business sector surged 3 percent in 1992, the strongest gain since 1975.

The substantial slack in labor markets and improvements in productivity growth have contributed to downward pressure on the inflation rate. The consumer price index rose just 3 percent in 1992, and excluding volatile food and energy prices, the increase was the lowest in twenty years. Inflation expectations, while lagging somewhat actual inflation developments, have moved down gradually.

### Recent Monetary Policy

In the circumstances of hesitant economic growth and downward pressures on inflation, monetary policy in 1992 was directed at fostering a more vigorous, but sustainable, rebound, consistent with progress toward price stability. The Federal Reserve, extending a series of policy moves that began in mid-1989, eased policy a number of times in 1992. We reduced the federal funds rate by a total of 1 percentage point by providing additional bank reserves and by reducing the discount rate. In addition, we again lowered reserve requirements for depository institutions.

These actions helped intermediate- and long-term interest rates move lower. During 1992, the yield on long-term Treasury bonds averaged nearly 1/2 percentage point lower than in the previous year. In the last few weeks, these reductions have been extended, bringing the rate on long-term Treasuries below 7 percent--the lowest since the early 1970s.

The declines in intermediate- and long-term interest rates have helped foster significant balance sheet restructuring by households and by business firms. Low mortgage rates have encouraged many households to refinance existing mortgage debt, and some have used the opportunity to tap into home equity to pay off consumer credit. Lower interest rates on mortgage as well as consumer credit, combined with more moderate growth of household debt, have resulted in a considerable reduction in household debt service payments since their 1990-1991 peak. The lower levels of long-term interest rates also have helped buoy house prices as well as stock prices. These factors may well have contributed to the substantial acceleration in personal consumption expenditures over the second half of 1992.

In the business sector, balance sheet restructuring activity has been encouraged by the high level of stock prices as well as relatively low long-term interest rates. Nonfinancial corporations stepped up their issuance of equity shares and bonds last year. These issues frequently were used to pay down bank debt as well as bonds carrying relatively high interest rates, and thus helped lengthen liability structures while reducing the interest cost of debt. In the nonfinancial business sector, net interest payments as a percent of cash flow are estimated to have reversed roughly two-thirds of the runup that occurred during the previous economic expansion.

Financial institutions also strengthened their financial positions. Commercial banks, for instance, considerably bolstered their risk-based and total capital ratios. In addition, their liquidity increased substantially as a result of their purchases of a large volume of Treasury and mortgage-backed securities. With their financial position more secure and the economy firming, banks no longer tightened business lending terms and standards in 1992, however, very little, if any, easing of lending conditions occurred either, and credit remained somewhat difficult for smaller firms to obtain.

The less accommodative stance of banks as well as the reluctance of firms and households to take on debt and the focus of borrowing on long-term markets have resulted in a rechanneling of credit flows outside of depository institutions. This rechanneling, in turn, has markedly affected the behavior of the monetary aggregates in relation to income. Both M2 and M3 expanded very sluggishly in 1992, leaving both aggregates 1/2 percentage point below the ranges set by the Federal Open Market Committee. Domestic nonfinancial

sector debt, by contrast, expanded appreciably more quickly, 4-1/2 percent, leaving this aggregate at the bottom of its range

The relatively slow growth of the broad monetary aggregates in 1992 was associated with much brisker growth of nominal income, that is, velocity increased considerably. A number of factors appeared to contribute to the strength in income relative to money growth. The steep yield curve encouraged households to shift funds from deposits into longer-term instruments, especially bond and stock mutual funds. In addition, interest rate incentives encouraged some households to use deposit balances to pay off or avoid taking on additional debt. Much of business and household borrowing was funded in the open markets, either through direct issuance of securities, in the case of businesses, or through issuance by banks and thrifts of securities backed by mortgage and consumer debt. Depository institutions generally sought to restrain growth in their balance sheets as a result of market and regulatory factors. Although some small businesses continued to experience unusual difficulties in obtaining credit, most other sectors remained able to tap credit, and thus the restraint on credit by banking institutions had only a modest negative impact on the overall economy. The net impact of these developments is that the economy was able to grow at a fairly good pace, particularly in the second half of the year, despite very slow money growth.

#### Economic Outlook and Monetary Policy Plans for 1993

Many of the factors that contributed to the unusual strength of velocity in 1992 appear likely to continue this year. Accordingly, the Federal Open Market Committee has decided to lower the target ranges for the monetary aggregates by one-half percentage point. The new range for M2 is 2 to 6 percent, and that for M3 is 1/2 to 4-1/2

percent. The lower ranges do not indicate a change in the Federal Reserve's monetary policy. Rather, they are a result of technical factors that are altering the money-income relationship. This view is reflected in the FOMC's decision to leave the range for domestic nonfinancial sector debt unchanged at 4-1/2 to 8-1/2 percent.

Although we have made some progress in understanding the factors that recently have affected money growth, considerable uncertainties regarding the money-income relationship remain. The upper ends of the monetary ranges provide substantial room for more rapid money growth should velocity tend to return to previous patterns, while growth in the lower parts of the ranges could be appropriate should velocity continue to strengthen.

Some of the same uncertainties that affect the money-income relationship also affect the outlook for income growth itself, including those regarding credit availability and attitudes of borrowers toward credit. The effects of these factors in limiting economic growth may be slowly ebbing. As I noted earlier, households, firms, and financial institutions have made considerable progress in cleaning up their balance sheets, which should help to reduce impediments to the flow of credit. Still, borrowers and lenders alike in the last few years have become a good deal more cautious about the use of credit, this development, while restraining aggregate demand in the short run, is likely to contribute to the sustainability of the expansion over the longer term.

A rebound in commercial real estate construction is still several years off. However, there are some signs that prices of commercial real estate are bottoming in certain areas. If this proves to be the case, it could bode well for borrowing on the basis of real estate collateral. Loan officers are likely to remain chary about

extending such loans as long as declining prices and illiquid real estate markets make it difficult to assess the future value of collateral. But as uncertainties about loan losses and capital positions ebb, banks are likely to become gradually more willing to extend credit generally.

The Federal Reserve is working closely with other banking regulators to ensure that undue impediments to credit flows are removed. In addition, we continue to monitor indicators of the availability of credit and take them into account in formulating monetary policy. They have been an important factor behind our measures to reduce short-term interest rates in the past few years, and our reductions in reserve requirements were intended to reduce depository institutions' costs and foster a better flow of credit.

The improvements in household balance sheets probably supported the gains in consumption spending in the second half of 1992. Declines in the unemployment rate, by fostering a sense of a stabilizing jobs situation, may also have played a role. Going forward, the employment picture will probably continue to be an important factor governing the pace of consumption spending. It is possible that the recent strong gains in productivity will be extended and may damp employment growth temporarily. But productivity growth will boost real wages over time and contribute to rising living standards of our citizens.

Certain other factors will probably continue to restrain growth of the economy in 1993. These factors include the budgetary problems of state and local governments, the downsizing of the defense sector, and slow growth or recession in the economies of some of our major trading partners. Those regions of the country that have

particular concentrations of defense-related employment may continue to experience soft conditions during 1993

Impediments to growth thus remain, but they have diminished significantly. Against this background, the central tendency of the governors' and Federal Reserve Bank presidents' forecasts is for real GDP to expand at a 3 to 3-1/4 percent in 1993. This growth would be expected to be associated with some decline in the unemployment rate. Inflation is expected to remain well contained.

Looking ahead, the strategy of monetary policy will be to provide sufficient liquidity to support the economic expansion while containing inflationary pressures. The existing slack implies that the economy can grow more rapidly than potential GDP for a time, permitting further reductions in the unemployment rate even while further progress toward price stability is made. As I have often emphasized, monetary policy, by achieving and maintaining price stability, can foster a stable economic and financial environment that is conducive to private economic planning, savings, investment, and productivity and economic growth. In light of the uncertainties in the economic outlook and in the relationship between the monetary aggregates and the economy, the Federal Reserve will need to continue to monitor carefully a variety of economic and financial indicators in conducting monetary policy this year and make adjustments in our stance as necessary.

#### The Role of Fiscal Policy

Fiscal policy, also, can make an important contribution toward enhancing the ability of our economy to produce rising living standards. The case for bringing down the structural budget deficit is compelling. The deficit has for some time been eroding the foundations of our economic strength. Pressures on credit markets

resulting from large federal deficits have led to high real interest rates, which in turn have curtailed investment in productive plant and equipment that would have boosted growth in real wages and output. The federal budget deficits are of particular concern because they have occurred in the context of very low private saving and have contributed to large current account deficits.

Substantial reductions in structural budget deficits, conversely, would confer appreciable benefits on the economy. The absorption of private savings by the government would be reduced. Concerns about the government's future claim on real resources would be lowered, and inflation expectations might well decline. As a result, nominal and real intermediate- and long-term interest rates would be substantially lower than otherwise. The lower level of real interest rates would encourage capital formation in the private sector--particularly investment in longer-lived capital--and would boost productivity growth and real incomes.

The President is to be commended for placing on the table a serious proposal for the reduction of structural budgetary deficits. Discussion about this proposal, and alternatives to it, has already begun in the Congress and in public forums across the country. The debate will be intensely political in the best sense of the word, and identifying what is in the long-term interest of the country will not be easy. But reducing the structural deficit is crucial. And action must be taken now. Postponing action would only extend the pattern of sluggish growth of the capital stock and, with incomes and living standards lagging, would ultimately make it even more difficult to engage in the programmatic actions that are necessary.

I have recently articulated certain key points that I believe are useful to keep in mind in evaluating alternative fiscal approaches. Let me repeat them.

First, current services outlays under present law rise faster than the tax base and would thus require ever-increasing tax rates simply to keep the budget deficit as a percent of nominal income from beginning to rise again after the mid 1990s. Such tax rate increases could stifle incentives and dampen economic growth and, incidentally, tax revenues. Hence, there is no alternative to achieving much slower growth of health-related and other outlays.

Second, we can no longer afford to hope to inflate or grow our way out of structural budget deficits. Given the explicit and implicit indexing of receipts and expenditures, higher inflation would not reduce the deficit, and even under optimistic assumptions regarding productivity growth, budget deficits would remain massive.

Finally, I find misplaced the fear that deficit reduction would be overdone and create an undesirable degree of "fiscal drag." It seems to me highly unlikely that in the current political environment the Congress and the Administration would cut too much too soon from the deficit. Moreover, given the lags in the impact of changes in fiscal programs on the economy, a program oriented toward fiscal consolidation is unlikely to have significant restraining effects on the economy in the near term. Indeed, the President's proposal would likely involve a modest degree of fiscal stimulus over the first year.

At this pivotal moment, I should emphasize that the Federal Reserve shares with the Congress and the Administration the goal of maximum sustainable economic growth. I assure you that the Federal Reserve will do its part to support your efforts. We at the Federal

Reserve intend to continue to foster the economic expansion in the near term while using the tools at our disposal to promote a financial environment conducive to sustainable long-term growth Fiscal policymakers in turn, by taking difficult but necessary measures to reduce the structural deficit now, can enhance the growth of the economy and promote rising living standards for the American people for years to come