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Testimony by

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Chairman

Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

United States Congress

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Mr. Chairman and members of the Committee, as you know, the Federal Reserve will be meeting later this week and will submit its semiannual report on monetary policy to the Congress in late February. At that time, I will be in a position to address more specifically our expectations for economic growth and inflation and for monetary policy in 1994. Under the circumstances, my opening remarks this morning will focus on identifying the major tendencies currently visible in the economy and the broad considerations that will likely be shaping our policy decisions in the weeks and months ahead.

As you may recall, in my appearances before this Committee in recent years, I discussed in detail the structural imbalances that I believed were impeding U.S. economic growth. I referred in particular to the enormous strains on the balance sheets of many households and businesses. Those strains, which grew out of the excessive debt expansion of the 1980s, were exacerbated by the subsequent weakness in real estate prices in the early 1990s. Moreover, these difficulties spilled over to the financial intermediaries, which--faced with mounting loan losses and with pressure from the markets and regulators to improve their capital ratios--restricted credit supplies to many small firms and other borrowers.

Considerable progress has been made in correcting these imbalances. Many households and businesses have materially improved their financial positions--as evidenced by the drop in debt-servicing burdens for all sectors and the decline in debt-to-equity ratios for businesses. In addition, banks and other financial institutions, having replenished depleted capital bases, have begun to demonstrate a greater willingness to make loans.

The Federal Reserve, through its deliberately accommodative stance, has played a key role in the restructuring process. But it is

important to emphasize that monetary policy must not overstay accommodation. Maintaining the confidence of financial market participants has been crucial for sustaining the declines in inflation expectations and, hence, in long-term interest rates that have facilitated the balance sheet adjustments to date. The actions taken last year to reduce the federal budget deficit have been instrumental in creating the basis for declining inflation expectations and easing pressures on long-term interest rates. Although we may not all agree on the specifics of the deficit reduction measures, the financial markets are apparently inferring that, on balance, the federal government will be competing less vigorously for private saving in the years ahead.

Partly because of these structural adjustments, the foundations of the economic expansion are looking increasingly well-entrenched. Real gross domestic product rose at an annual rate of nearly 3 percent in the third quarter of 1993, and the advance estimate for the fourth quarter indicated growth of nearly 6 percent. The labor market has also shown signs of notable improvement. Payroll employment rose about 2 million last year, and unemployment dropped appreciably, the unemployment rate for December 1993, at 6.4 percent, was almost a full percentage point below the level of late 1992.

The greater buoyancy in economic activity of late has been evident across the household and business sectors. Housing construction, stimulated by mortgage rates that are the lowest in more than twenty-five years, has increased markedly, and consumer spending, after hitting a lull in the first quarter of 1993, has posted sizable gains over the past three quarters. Outlays on consumer durable goods have been especially robust, in part to make up for the spending on motor vehicles that was deferred during the 1990-91 recession and the

early expansion period. In addition, the pickup in home sales is bolstering purchases of furniture and appliances.

Business fixed investment was very strong throughout 1993. It rose nearly 15 percent in real terms over the four quarters of the year, and order books for early 1994 are apparently filling rapidly. Stimulated by dramatic innovations in products and extensive price-cutting by the computer manufacturers, real outlays for office and computing equipment have continued to soar as cost-conscious businesses have rushed to exploit the new technologies. And with a favorable outlook for overall business sales, ample profits and cash flows, and relatively low cost of capital, firms have also increased their outlays on more traditional types of equipment. In addition, activity in the nonresidential construction sector finally is recovering from the depressed levels of the past few years.

Business inventories have been expanding only moderately in the aggregate in recent quarters, and stocks generally are lean, especially at manufacturing firms. Should businesses decide that higher levels of stocks are appropriate, we could see production boosted substantially over the next few quarters. Order lead times on the delivery of materials, however, remain low and do not, at least for now, suggest an acceleration in inventory investment.

Although recent economic developments, on the whole, have been favorable, the expansion has remained uneven. In the labor market, firms' efforts to restructure and improve productivity are continuing to restrain hiring, and concerns about job security persist. In addition, employers seem to be relying to an unusual degree on the use of overtime and temporary employees, in part perhaps because of the cost of providing fringe benefits to permanent full-time workers.

Moreover, not all business sectors are faring well. In particular, industries and regions that depend heavily on military spending will continue to experience sizable dislocations and disruptions. Also, many state and local governments are still struggling to reconcile a rising demand for services--especially in education, health, and crime prevention and correction--with limited growth in revenues.

Another concern is the weakness in the economies of some of our major trading partners, which has continued to constrain our export performance. Among the industrial countries, Canada and the United Kingdom appear to be emerging from deep slumps. However, signs of near-term improvements in Japan and continental Europe are scant. In Japan, asset deflation and associated financial problems continue to hold back growth, and in Germany, the far-reaching and costly adjustments associated with unification are still a restraining factor. In reaction to their economies' weak performances, monetary officials in the two countries fostered continued, cautious reductions in interest rates in 1993--as did officials in most other industrial countries. Government budget deficits generally worsened last year because of cyclical factors--and, in some cases, endeavors to stimulate demand. This deterioration of budget positions has limited the scope for further fiscal action in most countries.

As for the developing nations, economic conditions in Asia, fueled in part by exceptionally rapid growth in China, remained strong in 1993. In Latin America, however, real growth in Mexico fell to near zero, reflecting the depressing effects of a policy attempting to contain inflationary pressures and, for a time, growing uncertainty about whether the North American Free Trade Agreement (NAFTA) would be implemented.

The passage of the NAFTA in November represented a significant achievement for the North American continent. Besides reducing tariff and nontariff barriers on trade, the NAFTA extends liberalization to nontraditional areas, such as financial services and intellectual property. The trade agreement reached in December in the Uruguay Round of the GATT also covers some of these nontraditional areas. Approval by the Congress of the GATT agreement would likely stimulate U S exports of high-technology products. More broadly, these agreements are significant because they represent a rejection by the United States and our major trading partners of calls to turn inward in our economic and financial policies.

Interpreting the economic data for the United States over the next few months will be especially complicated. As you know, the Bureau of Labor Statistics is redesigning the household survey of employment. Also, many key indicators of production and spending will be affected by the earthquake in southern California and by the extraordinary weather conditions elsewhere. Nevertheless, although real GDP growth will almost surely slow appreciably from the rapid pace of late 1993, the economic fundamentals appear to be in place for further solid gains in the level of activity in the quarters ahead.

Recent data on prices and wages generally suggest that inflation remained in check through 1993, with the fourth-quarter to fourth-quarter change in the so-called core CPI edging down to 3.1 percent, the lowest reading since the early 1970s. To be sure, the acceleration in domestic economic activity has put some upward pressure on prices of a number of industrial materials, and measures of resource utilization are considerably higher than they were six months ago. Nonetheless, productivity growth has kept unit labor

costs subdued, and the broad measures of inflation have remained well contained

No doubt, many of the forces that helped restrain inflation in 1993 will continue to do so in 1994. Businesses will almost certainly remain intent on boosting productivity and controlling costs, and competition from abroad will continue to deter price increases--even in markets with limited spare domestic capacity.

History suggests, however, that higher price inflation tends to surface rather late in the business cycle and, hence, is not a good leading indicator of emerging troubles. By the time inflation pressures are evident, many imbalances that are costly to rectify have already developed, and only harsh monetary therapy can restore the financial stability necessary to sustain growth. This situation regrettably has arisen too often in the past.

The challenge of monetary policy is to detect such latent instabilities in time to contain them. Unfortunately, they are rarely visible until relatively far advanced. Moreover, once they are identified, policy actions to counter them take time to have their effects. Thus, the need of monetary policymakers for early indicators of developing problems is evident.

Historically, many such indicators have come from the financial sector. Money supply growth, the slope of the yield curve, quality spreads, and credit flows are among the variables that have helped the monetary authorities over the years act in advance of developing problems. In recent years, however, as a result of financial innovations and the unusual nature of the most recent business cycle, such indicators have, at times, produced misleading signals. The broad money and credit aggregates, for example, have

suggested declining inflation in the United States--but by far more than has actually occurred

Turning to nonfinancial variables, the degree of slack in the economy is important because it plays a major role in influencing whether inflation is increasing or decreasing. Over the longer haul, however, the level of inflation--that is, the rate of price change--depends crucially on price expectations, and not on the degree of slack. In the twenty years after World War II, most economists gave short shrift to expectations as a key determinant of inflation. Unemployment and inflation were considered simple tradeoffs. A lower rate of unemployment was thought to be associated with a higher, though constant, rate of inflation, conversely, a higher rate of unemployment was associated with a lower rate of inflation.

But the experience of the past three decades has demonstrated that what appears as a tradeoff between unemployment and inflation is quite ephemeral and misleading. Over the longer run, no such tradeoff is evident. Attempts to force-feed the economy beyond its potential have led in the past to higher inflation and, ultimately, not to lower unemployment, but to higher unemployment, as destabilizing forces and uncertainties associated with inflation induced economic contraction. In that regard, experience both here and abroad suggests that lower levels of inflation are conducive to the achievement of greater productivity and efficiency and, therefore, higher standards of living.

Currently we have the difficult task of assessing the appropriate time to move away from an extended period of monetary accommodation. The policy was established purposefully, largely to address the balance sheet strains I mentioned earlier. This monetary policy has been effective in that households and businesses are now in

stronger financial condition. But the job is not yet complete. Unfortunately, although we can assess how far the process of repairing balance sheets has proceeded, we do not know how much further it will go, mainly because of the difficulty of gauging desired levels of debt. What is clear, however, as I indicated here a year ago, is that we did not need to complete the job before evidence of faster economic growth would emerge. We have been growing in fits and starts, but smoothing through the data of the past two years, we have seen real GDP rise at a respectable 3 4 percent annual rate--sufficient to reignite job creation and significantly reduce unemployment.

A number of questions will have to be addressed by the Federal Open Market Committee. Foremost will be when is the appropriate time to move to a somewhat less accommodative level of short-term interest rates. We will have to make the judgment as to how long we can continue monetary accommodation, without sowing the seeds of another bout of inflationary instability accompanied by steeply rising long-term rates. Such an outcome would bode ill for economic growth in 1995 and beyond. On the other hand, we will also have to judge whether higher rates could slow the necessary completion of balance sheet repair to a point where economic growth is inhibited.

Short-term interest rates are currently abnormally low in real terms. At some point, absent an unexpected and prolonged weakening of economic activity, we will need to move them to a more neutral stance. Such an action would not be taken in order to cut off or limit the economic expansion, but rather to sustain and enhance it. The foremost contribution monetary policy can make to achieving higher standards of living in the United States is to provide the stable financial foundation for continued economic growth.