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Testimony by

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Board of Governors of the Federal Reserve System

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of the

Committee on Banking, Finance and Urban Affairs

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Mr Chairman and members of the Subcommittee, I am pleased to appear today to present the Federal Reserve's semiannual monetary policy report to the Congress

In the seven months since I gave the previous Humphrey-Hawkins testimony, the performance of the U S economy has improved appreciably Private-sector spending has surged, boosted in large part by very favorable financial conditions With mortgage rates at the lowest level in a quarter century, housing construction soared in the latter part of 1993 Consumer spending, especially on autos and other durables, has exhibited considerable strength Business fixed investment has maintained its previous rapid growth Important components of GDP growth in the second half of last year represented one-time upward adjustments to the level of activity in certain key sectors, and, with output in these areas unlikely to continue to climb as steeply, significant slowing in the rate of growth this year is widely expected In addition, the Southern California earthquake and severe winter weather may have dulled the force of the favorable trends in spending in January and February Nonetheless, as best we can judge, the economy's forward momentum remains intact

The strengthening of demand has been accompanied by favorable developments in labor markets In the second half of the year, employment continued to post moderate gains, and the unemployment rate fell further bringing its decrease over the full year to nearly 1 percentage point The unemployment rate in January apparently declined again on both the old and new survey bases

On the inflation front, the deterioration evident in some indicators in the first half of 1993 proved transitory For the year as a whole, the Consumer Price Index rose 2-3/4 percent, the smallest

increase since the big drop in oil prices in 1986. Broader inflation measures covering purchases by businesses as well as consumers rose even less. While declining oil prices contributed to last year's good readings, inflation measured by the CPI excluding food and energy also diminished slightly further, to just over a 3 percent rate for the whole year. In January the CPI remained quite well behaved on the whole. Not all signs have been equally favorable, however. For example, a number of commodity prices have firmed noticeably in recent months. And indications that such increases may be broadening engendered a back-up in long-term interest rates in recent days. In particular, the Philadelphia Federal Reserve Bank's survey showing a marked increase in prices paid by manufacturers early this year was taken as evidence of a more general emergence of inflation pressures.

It is important to note, however, that in the past such price data have often been an indication more of strength in new orders and activity than a precursor of rising inflation throughout the economy. In the current period, overall cost and price pressures still appear to remain damped. Wages do not seem to be accelerating despite scattered reports of some skilled-worker shortages, and advances in productivity early this year are holding down unit labor costs. Moreover, while private borrowing has picked up, broad money--to be sure a highly imperfect indicator of inflation in recent years--has continued to grow slowly.

Nonetheless, markets appear to be concerned that a strengthening economy is sowing the seeds of an acceleration of prices later this year by rapidly eliminating the remaining slack in resource utilization. Such concerns were reinforced by forecasts that recent

data suggest that revised estimates of fourth-quarter GDP to be released next week will show upward revisions from the preliminary 5.9 percent annual rate of growth. Rapid expansion late last year, it is apparently feared, may carry over into a much smaller deceleration of activity in 1994 than many had previously expected.

But it is too early to judge the degree of underlying economic strength in the early months of 1994. Anecdotal evidence does indicate continued underlying strength in manufacturers' new orders and production, but we will have a better reading on new orders on Thursday when preliminary data for January are released. The labor markets are signalling a somewhat less buoyant degree of activity as initial claims for unemployment insurance in recent weeks have moved up a notch. Clearly, the Federal Reserve will have to monitor carefully ongoing developments for indications of potential inflation or a strengthening in inflation expectations. As I have often noted, if the Federal Reserve is to promote long-term growth, we must contribute, as best we can, to keeping inflation pressures contained.

In this regard, a clear lesson we have learned over the decades since World War II is the key role of inflation expectations in the inflation process and in the overall performance of the macroeconomy. As I indicated in my testimony before the Joint Economic Committee last month, until the late 1960s, economists often paid inadequate attention 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 to be a tradeoff between unemployment and inflation is quite ephemeral and misleading. Attempts to force-feed the economy beyond its potential have led in the past to rising inflation as expectations ratcheted higher and, ultimately, not to lower unemployment but to higher unemployment, as destabilizing forces and uncertainties associated with accelerating inflation induced economic contraction. Over the longer run, no tradeoff is evident between inflation and unemployment. 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.

In fact, lower inflation historically has been associated not just with higher levels of productivity, but with faster growth of productivity as well. Why inflation and productivity growth are linked this way empirically is not clear. To some extent higher productivity growth may help to damp inflation for a time by lessening increases in unit labor costs. But the process of cause and effect in all likelihood runs the other way as well. Lower inflation and inflation expectations reduce uncertainty in economic planning and diminish risk premiums for capital investment. They also clarify the signals from movements in relative prices, and they encourage effort and resources to be devoted to wealth creation rather than wealth preservation. Many people do not have the knowledge of, or access to, ways of preserving wealth against inflation. For them, low inflation avoids an inequitable erosion of living standards.

The reduced inflation expectations of recent years have been accompanied by lower bond and mortgage interest rates, slower actual

inflation, falling unemployment, and faster trend productivity growth. The implication is clear: when it comes to inflation expectations, the nearer zero, the better.

It follows that price stability, with inflation expectations essentially negligible, should be a long-run goal of macroeconomic policy. We will be at price stability when households and businesses need not factor expectations of changes in the average level of prices into their decisions. How those expectations form is not always easy to discern, and they can for periods of time appear to be at variance with underlying economic forces. But history tells us that it is economic and financial forces and their consequences for realized inflation that ultimately shape inflation expectations.

Fiscal and monetary policy are important among those forces and have contributed to the decline in inflation expectations in recent years along with decreases in long-term interest rates. The actions taken last year to reduce the federal budget deficit have been instrumental in this regard. 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. Concerns that the deficit is out of control have diminished. In the extreme, explosive federal debt growth makes an eventual resort to the printing press and inflationary finance difficult to resist. By shrinking any perceived risk of this outcome, the deficit reduction package apparently had a salutary effect on longer-term inflation expectations.

The Federal Reserve's policies in recent years also have helped to damp inflation and inflation expectations. We were able to

do so, even while adopting an increasingly accommodative policy stance. By placing our actions in the context of a thorough analysis of the prevailing situation and of a longer-term underlying strategy, our move to greater accommodation could be seen as what it was--a deliberate effort to counter the various "headwinds" that were retarding the advance of the economy rather than a series of short-term actions taken without consideration for potential inflation consequences over time.

As I discussed with this Subcommittee last July, this longer-run strategy implies that the Federal Reserve must take care not to overstay an accommodative stance as the headwinds abate. But determining when a policy stance is becoming too accommodative is not an easy matter. Unfortunately, although subdued inflation is the hallmark of a successful monetary policy, current broad inflation readings are actually of limited use as a guide to the appropriateness of current instrument settings. Patently, price measurements over short time spans are subject to transitory special factors. More important, monetary policy affects inflation only with a significant lag. That a policy stance is overly stimulative will not become clear in the price indexes for perhaps a year or more. Accordingly, if the Federal Reserve waits until actual inflation worsens before taking countermeasures, it would have waited far too long. At that point, modest corrective steps would no longer be enough to contain emerging economic imbalances and to avoid a build-up of inflation expectations and a significant back-up of long-term interest rates. Instead, more wrenching measures would be needed, with unavoidable adverse side effects on near-term economic activity.

Inflation expectations likely have more of a forward-looking character than do measures of inflation itself, and, in principle, could be used as a direct guide to policy. But available surveys have limited coverage and are subject to sampling error. As I have testified previously, price-indexed bonds of various maturities, which would indicate underlying market inflation expectations, would be a useful adjunct to our information base for making monetary policy, providing there were a sufficiently broad and active market for them. In addition, the price of gold, which has been especially sensitive to inflation concerns, the exchange rate, and the term structure of interest rates can give important clues about changing expectations.

Of course, a number of factors in addition to inflation expectations affect all of these indicators to a degree. Short- and long-term rates, for example, tend to be highly correlated through time, in part because they are responding to the same business cycle pressures. Thus, when the Federal Reserve tightens reserve market conditions, it is not surprising to see some upward movement in long-term rates, as an aspect of the process that counters the imbalances tending to surface in the expansionary phase of the business cycle. The test of successful monetary policy in such a business-cycle phase is our ability to limit the upward movement of long-term rates from what it would otherwise have been with less effective policy. Moderate to low long-term rates, with rare exceptions, are an essential ingredient of sustainable long-term economic growth. When we take credible steps to head off inflation before it can begin to intensify, the effects on long-term rates are muted. By contrast, when Federal Reserve action is seen as lagging behind the need to counter a buildup of inflation pressures, long rates have tended to move sharply higher.



as eventually happened in the late 1970s. This suggests an important conclusion. Failure to tighten in a timely manner will lead to higher than necessary nominal long-term rates as inflation expectations intensify. Ultimately, short-term rates will be higher as well if policy initiatives lag behind inflation pressures. The higher short-term rates are required not only to take account of rising inflation expectations, but also to provide the additional restraint on real rates necessary to reverse the destabilizing inflation process.

For decades, the monetary aggregates, especially M2, provided generally reliable early warning signals of emerging inflationary imbalances. But, as I have discussed in detail in previous testimonies and will touch on later in this statement, the signals they have sent in recent years have been effectively jammed by structural changes in financial markets and the unusual nature of the current business cycle.

Our monetary policy strategy must continue to rest, then, on ongoing assessments of the totality of incoming information and appraisals of the probable outcomes and risks associated with alternative policies. Our purpose over the longer run is to help the economy grow at its greatest potential over time. To do so, we must move toward a posture of policy neutrality--that is, a level of real short-term rates consistent with sustained economic growth at the economy's potential. That level, of course, is difficult to discern and, obviously, is not a fixed number but moves with developments within the economy and financial markets.

Over a period of several years starting in 1989, the Federal Reserve progressively eased its policy stance, in the process reducing real short-term interest rates to around zero by the autumn of 1992.

We undertook those easing actions in response to evidence of a variety of unusual restraints on spending. Households and nonfinancial businesses on the borrowing side and many lenders, including depository institutions, were suffering from balance-sheet strains. These difficulties stemmed from previous overleveraging combined with reductions in net worth from impairments to asset quality, through, for example, falling values of commercial real estate. Corporate restructuring and defense cutbacks compounded the problems of the economy by reducing job opportunities and fostering a more general sense of insecurity about employment prospects.

The deliberate maintenance of low short-term rates for a considerable period was intended to decrease the drag on the economy created by these headwinds. Households and businesses could refinance outstanding debt at much reduced interest cost. In addition, lower rates and improved performance by borrowers would take the pressure off of depository institutions, helping them recapitalize. Low interest rates, along with reduced financial strains, would encourage private spending to pick up the slack left by defense cutbacks. Once financial positions were well on the road to recovery, and employment and confidence began to recover, it was believed that the economic expansion would gain self-sustaining momentum. At that point abnormally low real short-term real rates should no longer be needed.

As the Federal Open Market Committee (FOMC) surveyed the evidence at its February 4 meeting, a consensus developed that the balance of risks had, in fact, shifted. Debt repayment burdens had been lowered enough to unleash strong aggregate demand in the economy. Real short rates close to zero appeared to pose an unacceptable risk of engendering future problems. We concluded that our policy stance

could be made slightly less accommodative without threatening either the continued improvement in balance-sheet structures or, ultimately, the achievement of solid economic growth. Indeed, the firming in reserve market pressures was undertaken to preserve and protect the ongoing economic expansion by forestalling a future destabilizing buildup of inflationary pressures, which in our judgment would eventually surface if the level of policy accommodation that prevailed throughout 1993 were continued indefinitely. We viewed our move as low-cost insurance.

The projections of the FOMC members suggest a continuation of good economic performance in 1994, with reasonable growth and subdued inflation. The central tendencies of the economic forecasts made by governors and Bank presidents imply expectations that economic growth this year likely will be 3 percent or slightly higher. With this kind of growth, a further edging down of the unemployment rate from its January reading is viewed as a distinct possibility. Inflation, as measured by the overall CPI, is seen as rising only a little compared with 1993, even though last year's benefit from falling oil and tobacco prices may not be repeated, and last year's crop losses could buoy food prices in 1994.

There are, of course, considerable risks to this generally favorable outlook. Some observers have pointed to downside risks to economic activity associated with fiscal restraint and weak foreign economies. I believe these factors will have some effects, but they are likely to be less than feared. As for fiscal restraint, a good portion of the negative impact of last year's budget bill may already be behind us, as some households and businesses have adjusted their

behavior to the new structure of taxes and to curtailments in defense and other budget programs

The concern about weak foreign economies relates to the strength of foreign demand for U S exports going forward. Many of our major trading partners have been experiencing economic difficulties. But some already appear to be pulling out of recession and a number of others seem to have improved prospects. Moreover, containing inflation will keep increases in production costs of traded goods made in the United States subdued, so that our products will remain competitive in world markets. With competitive goods and an improving world economy, the growth of U S exports should strengthen this year, lessening the drag from the external sector on our output growth.

There are upside risks as well. Inventories have reached a low level relative to sales, suggesting the possibility of a boost to production from inventory rebuilding beyond that currently anticipated. In addition, with both borrowers and lenders in stronger financial condition, low interest rates have proven a powerful stimulant to spending. While we were reasonably convinced at the last FOMC meeting that a zero real federal funds rate put real short rates below a "neutral" level, we cannot tell this Subcommittee, with assurance, precisely where the level of neutrality currently resides. To promote sustainable growth, history suggests that real short-term rates are more likely to have to rise than fall from here. I cannot, however, tell you at this time when any such rise would occur, I would hope that part of any increase in real short-term rates ultimately would be accomplished through further declines in inflation expectations rather than through higher nominal short-term rates.

In assessing our policy stance, we will continue to monitor developments in money and credit, but in 1994 as in 1993 the FOMC is unlikely to be able to put a great deal of weight on the behavior of these aggregates relative to their ranges. We have set the ranges as best we can in an evolving financial situation to be consistent with our objectives for sustained growth and low inflation.

Based on our experience in 1993 and expectations about financial relationships for 1994, the FOMC judges that the growth of money and credit this year will stay within the annual ranges set provisionally last July, which were reaffirmed at its meeting early this month. Specifically, these ranges call for growth of 1 to 5 percent for M2, 0 to 4 percent for M3, and 4 to 8 percent for domestic nonfinancial sector debt. The ranges are the same as the final specifications established last July for 1993.

The final specifications for last year had gone through two rounds of technical downward adjustment after they were first set provisionally in July 1992. These downward revisions reflected the FOMC's recognition that the relationship between spending and money holdings was departing markedly from historical norms. Financial intermediation was moving away from past patterns, as flows of funds were increasingly being rechanneled away from banks toward securities markets, notably via bond and stock mutual funds. Also, banks were relying more heavily on nondeposit funding sources, such as equity and subordinated debt, as they strengthened their capital positions.

In the event, growth of M2 and M3 last year came in above the lower bounds of their reduced ranges with only 1/2 percentage point to spare. M2 grew at 1-1/2 percent and M3 at 1/2 percent over the year as a whole. Even so, nominal GDP advanced more than 5 percent over

the year, extending rapid increases in the velocities of broad money through another year. The discrepancy between the growth rates of nominal GDP and broad money diminished some from that of 1992, but was still unusual in the face of steady short-term interest rates.

Somewhat faster growth of M2 and M3 this year than last year may be in prospect. The governors' and presidents' outlook calls for a small stepup in nominal spending, and the factors depressing growth of the broader aggregates relative to the expansion of spending could well abate to some degree. In particular, the diversion of savings from retail deposits and money funds toward bond and stock mutual funds may lessen, as household portfolios more fully complete the adjustment to the latter's heightened availability. Now that banks have achieved healthier capitalization, they may more readily issue large time deposits instead of equity and subordinated debt to support stepped-up loan growth. Just how far these developments will go, however, is difficult to predict, so the prospective relationship between spending and broad money remains highly uncertain. The FOMC will continue to monitor the behavior of money supply measures for evidence about underlying economic and financial developments more generally, but it will still have to base its assessments regarding appropriate policy actions on a wide variety of economic indicators.

Among those indicators, the Federal Reserve will again pay attention to credit market developments, especially for any light they can shed on the strength of household and corporate balance sheets and spending propensities. The overall debt aggregate put in a repeat performance last year, again growing by around 5 percent, even as the advance of nominal GDP moderated to a similar pace. But this steady

debt growth incorporated an upturn in private borrowing, as the borrowing of the federal government slackened. Households in particular showed a heightened willingness to take on debt to help finance strong purchases of homes and consumer durables. At the same time, massive mortgage refinancings at much reduced interest rates contributed to further reductions in household debt-service burdens relative to income to a level last seen in the mid-1980s. For businesses as well, the bite taken out of cash flow by interest payments was shrunk to a size last observed in the mid-1980s, partly through the refinancing of higher-cost debt and continued equity issuance. Although business borrowing firmed a little, it remained subdued, as enough internal funds were available to finance the bulk of hefty capital expenditures.

Looking ahead, federal borrowing is scheduled to diminish further this year, partly reflecting deficit reduction measures. Borrowing by nonfederal sectors should continue to strengthen, prodded by the anticipated pickup in nominal GDP and the healthier financial condition already attained by households and businesses.

In conclusion, the Federal Reserve has welcomed both the strengthening in activity and the generally subdued price trends, because the intent of our monetary policy in recent years has been to foster precisely this kind of healthy economic performance. Looking forward, our policy approach will be to endeavor to select on a continuing basis the monetary instrument settings that will minimize economic instabilities and maximize living standards over time. The outlook, as a result of subdued inflation and still low long-term interest rates, is the best we have seen in decades. It is important

that we do everything we can to turn that favorable outlook into reality