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Statement of

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I appreciate the opportunity this morning to present the Federal Reserve's semiannual report on monetary policy.

The past decade has been extraordinary for the American economy and monetary policy. The synergies of key technologies markedly elevated prospective rates of return on high-tech investments, led to a surge in business capital spending, and significantly increased the underlying growth rate of productivity. The capitalization of those higher expected returns boosted equity prices, contributing to a substantial pickup in household spending on new homes, durable goods, and other types of consumption generally, beyond even that implied by the enhanced rise in real incomes.

When I last reported to you in July, economic growth was just exhibiting initial signs of slowing from what had been an exceptionally rapid and unsustainable rate of increase that began a year earlier.

The surge in spending had lifted the growth of the stocks of many types of consumer durable goods and business capital equipment to rates that could not be continued. The elevated level of light vehicle sales, for example, implied a rate of increase in the number of vehicles on the road hardly sustainable for a mature industry. And even though demand for a number of high-tech products was doubling or tripling annually, in many cases new supply was coming on even faster. Overall, capacity in high-tech manufacturing industries rose nearly 50 percent last year, well in excess of its rapid rate of increase over the previous three years. Hence, a temporary glut in these industries and falling prospective rates of return were inevitable at some point. Clearly, some slowing in the pace of spending was necessary and expected if the economy was to progress along a balanced and sustainable growth path.

But the adjustment has occurred much faster than most businesses anticipated, with the process likely intensified by the rise in the cost of energy that has drained business and household purchasing power. Purchases of durable goods and investment in capital equipment declined in the fourth quarter. Because the extent of the slowdown was not anticipated by businesses, it induced some backup in inventories, despite the more advanced just-in-time technologies that have in recent years enabled firms to adjust production levels more rapidly to changes in demand. Inventory-sales ratios rose only moderately; but relative to the levels of these ratios implied by their downtrend over the past decade, the emerging imbalances appeared considerably larger. Reflecting these growing imbalances, manufacturing purchasing managers reported last month that inventories in the hands of their customers had risen to excessively high levels.

As a result, a round of inventory rebalancing appears to be in progress. Accordingly, the slowdown in the economy that began in the middle of 2000 intensified, perhaps even to the point of growth stalling out around the turn of the year. As the economy slowed, equity prices fell, especially in the high-tech sector, where previous high valuations and optimistic forecasts were being reevaluated, resulting in significant losses for some investors. In addition, lenders turned more cautious. This tightening of financial conditions, itself, contributed to restraint on spending.

Against this background, the Federal Open Market Committee (FOMC) undertook a series of aggressive monetary policy steps. At its December meeting, the FOMC shifted its announced assessment of the balance of risks to express concern about economic weakness, which encouraged declines in market interest rates. Then on January 3, and again on January 31, the FOMC reduced its targeted federal funds rate 1/2 percentage point, to its current level of

5-1/2 percent. An essential precondition for this type of response was that underlying cost and price pressures remained subdued, so that our front-loaded actions were unlikely to jeopardize the stable, low inflation environment necessary to foster investment and advances in productivity.

The exceptional weakness so evident in a number of economic indicators toward the end of last year (perhaps in part the consequence of adverse weather) apparently did not continue in January. But with signs of softness still patently in evidence at the time of its January meeting, the FOMC retained its sense that the risks are weighted toward conditions that may generate economic weakness in the foreseeable future.

Crucial to the assessment of the outlook and the understanding of recent policy actions is the role of technological change and productivity in shaping near-term cyclical forces as well as long-term sustainable growth.

The prospects for sustaining strong advances in productivity in the years ahead remain favorable. As one would expect, productivity growth has slowed along with the economy. But what is notable is that, during the second half of 2000, output per hour advanced at a pace sufficiently impressive to provide strong support for the view that the rate of growth of structural productivity remains well above its pace of a decade ago.

Moreover, although recent short-term business profits have softened considerably, most corporate managers appear not to have altered to any appreciable extent their long-standing optimism about the future returns from using new technology. A recent survey of purchasing managers suggests that the wave of new on-line business-to-business activities is far from cresting. Corporate managers more generally, rightly or wrongly, appear to remain remarkably

sanguine about the potential for innovations to continue to enhance productivity and profits. At least this is what is gleaned from the projections of equity analysts, who, one must presume, obtain most of their insights from corporate managers. According to one prominent survey, the three- to five-year average earnings projections of more than a thousand analysts, though exhibiting some signs of diminishing in recent months, have generally held firm at a very high level. Such expectations, should they persist, bode well for continued strength in capital accumulation and sustained elevated growth of structural productivity over the longer term.

The same forces that have been boosting growth in structural productivity seem also to have accelerated the process of cyclical adjustment. Extraordinary improvements in business-to-business communication have held unit costs in check, in part by greatly speeding up the flow of information. New technologies for supply-chain management and flexible manufacturing imply that businesses can perceive imbalances in inventories at a very early stage--virtually in real time--and can cut production promptly in response to the developing signs of unintended inventory building.

Our most recent experience with some inventory backup, of course, suggests that surprises can still occur and that this process is still evolving. Nonetheless, compared with the past, much progress is evident. A couple of decades ago, inventory data would not have been available to most firms until weeks had elapsed, delaying a response and, hence, eventually requiring even deeper cuts in production. In addition, the foreshortening of lead times on delivery of capital equipment, a result of information and other newer technologies, has engendered a more rapid adjustment of capital goods production to shifts in demand that result from changes in firms' expectations of sales and profitability. A decade ago, extended backlogs

on capital equipment meant a more stretched-out process of production adjustments.

Even consumer spending decisions have become increasingly responsive to changes in the perceived profitability of firms through their effects on the value of households' holdings of equities. Stock market wealth has risen substantially relative to income in recent years--itself a reflection of the extraordinary surge of innovation. As a consequence, changes in stock market wealth have become a more important determinant of shifts in consumer spending relative to changes in current household income than was the case just five to seven years ago.

The hastening of the adjustment to emerging imbalances is generally beneficial. It means that those imbalances are not allowed to build until they require very large corrections. But the faster adjustment process does raise some warning flags. Although the newer technologies have clearly allowed firms to make more informed decisions, business managers throughout the economy also are likely responding to much of the same enhanced body of information. As a consequence, firms appear to be acting in far closer alignment with one another than in decades past. The result is not only a faster adjustment, but one that is potentially more synchronized, compressing changes into an even shorter time frame.

This very rapidity with which the current adjustment is proceeding raises another concern, of a different nature. While technology has quickened production adjustments, human nature remains unaltered. We respond to a heightened pace of change and its associated uncertainty in the same way we always have. We withdraw from action, postpone decisions, and generally hunker down until a renewed, more comprehensible basis for acting emerges. In its extreme manifestation, many economic decisionmakers not only become risk averse but attempt to disengage from all risk. This precludes taking any initiative, because risk is inherent in every

action. In the fall of 1998, for example, the desire for liquidity became so intense that financial markets seized up. Indeed, investors even tended to shun risk-free, previously issued Treasury securities in favor of highly liquid, recently issued Treasury securities.

But even when decisionmakers are only somewhat more risk averse, a process of retrenchment can occur. Thus, although prospective long-term returns on new high-tech investment may change little, increased uncertainty can induce a higher discount of those returns and, hence, a reduced willingness to commit liquid resources to illiquid fixed investments.

Such a process presumably is now under way and arguably may take some time to run its course. It is not that underlying demand for Internet, networking, and communications services has become less keen. Instead, as I noted earlier, some suppliers seem to have reacted late to accelerating demand, have overcompensated in response, and then have been forced to retrench--a not-unusual occurrence in business decisionmaking.

A pace of change outstripping the ability of people to adjust is just as evident among consumers as among business decisionmakers. When consumers become less secure in their jobs and finances, they retrench as well.

It is difficult for economic policy to deal with the abruptness of a break in confidence. There may not be a seamless transition from high to moderate to low confidence on the part of businesses, investors, and consumers. Looking back at recent cyclical episodes, we see that the change in attitudes has often been sudden. In earlier testimony, I likened this process to water backing up against a dam that is finally breached. The torrent carries with it most remnants of certainty and euphoria that built up in earlier periods.

This unpredictable rending of confidence is one reason that recessions are so difficult to

forecast. They may not be just changes in degree from a period of economic expansion, but a different process engendered by fear. Our economic models have never been particularly successful in capturing a process driven in large part by nonrational behavior.

Although consumer confidence has fallen, at least for now it remains at a level that in the past was consistent with economic growth. And as I pointed out earlier, expected earnings growth over the longer-run continues to be elevated. If the forces contributing to long-term productivity growth remain intact, the degree of retrenchment will presumably be limited. Prospects for high productivity growth should, with time, bolster both consumption and investment demand. Before long in this scenario, excess inventories would be run off to desired levels.

Still, as the FOMC noted in its last announcement, for the period ahead, downside risks predominate. In addition to the possibility of a break in confidence, we don't know how far the adjustment of the stocks of consumer durables and business capital equipment has come. Also, foreign economies appear to be slowing, which could damp demands for exports; and, although some sectors of the financial markets have improved in recent weeks, continued lender nervousness still is in evidence in other sectors.

Because the advanced supply-chain management and flexible manufacturing technologies may have quickened the pace of adjustment in production and incomes and correspondingly increased the stress on confidence, the Federal Reserve has seen the need to respond more aggressively than had been our wont in earlier decades. Economic policymaking could not, and should not, remain unaltered in the face of major changes in the speed of economic processes. Fortunately, the very advances in technology that have quickened economic adjustments have

also enhanced our capacity for real-time surveillance.

As I pointed out earlier, demand has been depressed by the rise in energy prices as well as by the needed slowing in the pace of accumulation of business capital and consumer durable assets. The sharp rise in energy costs pressed down on profit margins still further in the fourth quarter. About a quarter of the rise in total unit costs of nonfinancial, nonenergy corporations reflected a rise in energy costs. The 12 percent rise in natural gas prices last quarter contributed directly, and indirectly through its effects on the cost of electrical power generation, about one-fourth of the rise in overall energy costs for nonfinancial, non-energy corporations; increases in oil prices accounted for the remainder.

In addition, a significant part of the margin squeeze not directly attributable to higher energy costs probably has reflected the effects of the moderation in consumer outlays that, in turn, has been due in part to higher costs of energy, especially for natural gas. Hence, it is likely that energy cost increases contributed significantly more to the deteriorating profitability of nonfinancial, non-energy corporations in the fourth quarter than is suggested by the energy-related rise in total unit costs alone.

To be sure, the higher energy expenses of households and most businesses represent a transfer of income to producers of energy. But the capital investment of domestic energy producers, and, very likely, consumption by their owners, have provided only a small offset to the constraining effects of higher energy costs on spending by most Americans. Moreover, a significant part of the extra expense is sent overseas to foreign energy producers, whose demand for exports from the United States is unlikely to rise enough to compensate for the reduction in domestic spending, especially in the short-run. Thus, given the evident inability of energy users,

constrained by intense competition for their own products, to pass on much of their cost increases, the effects of the rise in energy costs does not appear to have had broad inflationary effects, in contrast to some previous episodes when inflation expectations were not as well anchored. Rather, the most prominent effects have been to depress aggregate demand. The recent decline in energy prices and further declines anticipated by futures markets, should they occur, would tend to boost purchasing power and be an important factor supporting a recovery in demand growth over coming quarters.

Economic Projections

The members of the Board of Governors and the Reserve Bank presidents foresee an implicit strengthening of activity after the current rebalancing is over, although the central tendency of their individual forecasts for real GDP still shows a substantial slowdown, on balance, for the year as a whole. The central tendency for real GDP growth over the four quarters of this year is 2 to 2-1/2 percent. Because this average pace is below the rise in the economy's potential, they see the unemployment rate increasing to about 4-1/2 percent by the fourth quarter of this year. The central tendency of their forecasts for inflation, as measured by the prices for personal consumption expenditures, suggests an abatement to 1-3/4 to 2-1/4 percent over this year from 2-1/2 percent over 2000.

Government Debt Repayment and the Implementation of Monetary Policy

Federal budget surpluses have bolstered national saving, providing additional resources for investment and, hence, contributing to the rise in the capital stock and our standards of living. However, the prospective decline in Treasury debt outstanding implied by projected federal budget surpluses does pose a challenge to the implementation of monetary policy. The Federal

Reserve has relied almost exclusively on increments to its outright holdings of Treasury securities as the "permanent" asset counterpart to the uptrend in currency in circulation, our primary liability. Because the market for Treasury securities is going to become much less deep and liquid if outstanding supplies shrink as projected, we will have to turn to acceptable substitutes. Last year the Federal Reserve System initiated a study of alternative approaches to managing our portfolio.

At its late January meeting, the FOMC discussed this issue at length, and it is taking several steps to help better position the Federal Reserve to address the alternatives. First, as announced on January 31, the Committee extended the temporary authority, in effect since late August 1999, for the Trading Desk at the Federal Reserve Bank of New York to conduct repurchase agreements in mortgage-backed securities guaranteed by the agencies as well as in Treasuries and direct agency debt. Thus, for the time being, the Desk will continue to rely on the same types of temporary open market operations in use for the past year and a half to offset transitory factors affecting reserve availability.

Second, the FOMC is examining the possibility of beginning to acquire under repurchase agreements some additional assets that the Federal Reserve Act already authorizes the Federal Reserve to purchase. In particular, the FOMC asked the staff to explore the possible mechanisms for backing our usual repurchase operations with the collateral of certain debt obligations of U.S. states and foreign governments. We will also be consulting with the Congress on these possible steps before the FOMC further considers such transactions. Taking such assets in repurchase operations would significantly expand and diversify the assets our counterparties could post in temporary open market operations, reducing the potential for any impact on the pricing of private

sector instruments.

Finally, the FOMC decided to study further the even longer-term issue of whether it will ultimately be necessary to expand the use of the discount window or to request the Congress for a broadening of its statutory authority for acquiring assets via open market operations. How quickly the FOMC will need to address these longer-run portfolio choices will depend on how quickly the supply of Treasury securities declines as well as the usefulness of the alternative assets already authorized by law.

In summary, although a reduced availability of Treasury securities will require adjustments in the particular form of our open market operations, there is no reason to believe that we will be unable to implement policy as required.