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Testimony by

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I appreciate this opportunity to appear before this Committee today. As you know, the Federal Reserve submitted its semi-annual monetary policy report to the Congress last week. That report, which we have distributed to you, describes in detail our plans for monetary policy, including the Federal Open Market Committee's ranges for growth of money and credit. My prepared remarks this morning will be confined to more general considerations of domestic and international economic policies within the context of recent and prospective developments.

The Economic Setting

The current economic expansion -- now extending into its fifth year -- is already among the longest in peacetime history. It is unusual in other respects as well, including the absence of certain signs of cyclical excesses that often develop after years of expansion. For instance, inventories have been held well within past relationships to sales, and spending by manufacturers for plant and equipment has, if anything, been restrained relative to prospective needs.

While the overall rate of economic growth has been rather moderate since mid-1984, averaging about 2-1/2 percent a year, that growth has been maintained despite strong pressures on sizable sectors of the economy. Oil exploration and development activity and agricultural prices have both been heavily affected by worldwide surpluses. Commercial construction in many areas is suffering from earlier over-building. Regions of the country in which those impacts have been particularly large have thus remained relatively depressed. Difficult as those regional conditions have been, however, many of the necessary adjustments are well advanced and other areas of the economy have been moving strongly ahead.

More importantly, both the inflation rate and interest rates, after four years of expansion, are substantially lower than when the recovery started. Homebuilding is being well maintained, and both capital and labor appear available to support further growth for some time without undue strain on resources. Certainly, conditions in financial markets, with stock prices exuberant and interest rates generally as low as at any time since the mid-1970s, appear supportive of new investment.

But if the traditional indicators of cyclical problems are largely absent, it is also evident that the economy is struggling with structural distortions and imbalances that, for us, have little precedent. Economic activity over the past two years has been supported very largely by consumption. That has been at the expense of reduced personal saving rates that, by world standards, were already chronically low. At the same time, the huge federal deficit is absorbing a disproportionate amount of our limited savings.

For a time, we have largely escaped the adverse consequences for financial markets of that insidious combination of low saving rates and high federal deficits by drawing on capital from abroad -- the flow of which in 1986 actually exceeded all the savings by U.S. households. The other side of that coin, however, is a massive trade and current account deficit, restraining growth in manufacturing generally and incentives for the industrial investment that we will need in the years ahead.

The simple facts are that we are spending more than we produce and that we are unable to finance at home both our investment needs and the federal deficit. Those are not conditions that are sustainable for long -- not when, as at present, the influx of capital from abroad cannot be traced to a surge in productive investment.

It's not sustainable from an economic perspective to pile up foreign debts while failing to make the investment that we need both to generate growth and to earn the money to service the debts.

It is not supportable politically, as the pressures on our industrial base are transmuted into demands for protection.

Ultimately it will not be supportable from an international perspective either, as the confidence that underlies the flow of foreign savings will be eroded.

Sooner or later, the process will stop. The only question is how.

The Broad Policy Approach

In concept, we could shut off the flow of imports by aggressive, broadbrush protectionist measures. But the result would be to drive up the rate of inflation and interest rates here, to damage growth abroad, and to invite retaliation. Instead of sustained and orderly growth, we would invite world-wide recession.

We could try to drive the dollar much lower -- or complacently sit back while the market forces produce that result. But that too would undermine the hard-won gains against inflation, and would risk dissipating the flow of foreign capital we, for the time being, need. The stability of financial markets would be jeopardized, and export prospects could be undercut by adverse effects on growth abroad.

Both of those courses were specifically rejected by the Finance Ministers and Central Bank Governors at their meeting in Paris last weekend.

Faced with similar circumstances, many smaller countries might reasonably embark upon strong austerity programs -- indeed sooner or later would be forced to undertake such programs. Large doses of fiscal and monetary restraint would be taken, risking recession in the short run, but also anticipating that exports would respond vigorously, imports would decline, and their economies would soon resume growth on a much sounder footing. But, in the context of a sluggish growth of the world economy, for the United States to take that course would entail particularly high risks and the results would be problematical at best.

There is a reasonable alternative. It is more complicated, but at the same time much more promising.

We can draw upon a combination of policy instruments to encourage the needed adjustments. Results may take time. But those results will come with greater certainty -- and they should be consistent with maintaining growth here and abroad, with progress toward underlying price stability, and with open markets.

That is, in fact, the course on which we collectively are embarked, and the course that was endorsed at the meetings in Paris.

To be sure, its success will require an unusual combination of discipline, patience, and international cooperation. However, given the stakes not just for the United States but for others, I don't think there is any real choice.

Important steps have already been taken in the needed directions. Most obviously, the value of the dollar vis-a-vis the currencies of other industrialized countries has declined substantially, placing our industry in a much stronger competitive position. The volume of exports is rising, despite relatively slow growth abroad. The deterioration in the trade deficit overall appears to have been stemmed, even if clear evidence of a reversal is still lacking. Moreover, while the depreciation of the dollar inevitably carries in its train rising import prices, we have been fortunate that the initial impact on the overall price level was more than offset by falling oil and other commodity prices. The underlying inflation rate, measured by trends in wages relative to productivity, has continued to fall.

Given the size of the exchange rate adjustments already made among the major countries, there is a point beyond which further instability would damage both our objectives and those of our trading partners. Against that background, the Ministers and Governors of the leading industrialized countries collectively agreed last weekend that "their currencies [are] within ranges broadly consistent with underlying economic fundamentals" on the assumption certain broad economic policies are carried out.

We have been fortunate that the flow of capital from abroad, buoyed by the rising stock and bond markets here and by some declines in interest rates abroad, was well maintained as the dollar depreciated. Nevertheless, as we succeed in reducing our current account deficit, the net capital inflow will decline as well. That emphasizes the critical importance of one of the policy assumptions referred to in the weekend statement -- that the United States move ahead with further reductions in the federal budget deficit which absorbs so much of our own savings.

The progress being made in that direction this year is heartening. But that can only be a start. The projected reduction of $40 to $50 billion this year is from a record high deficit of more than $220 billion in fiscal 1986 -- more than 5 percent of the GNP -- and it is being assisted by some temporary factors. Progress next year will be harder.

Success in my mind will require a reasonably steady downward pace in the deficit as the economy grows -- and that progress will need to be maintained by measures that can be sustained, year after year. Failing that, it's hard to see how a sustained decline in the trade deficit, if possible at all in the face of huge budget deficits, will bring net benefit to the economy. The clear implication would be congested capital markets, higher interest rates, strong inflationary dangers, and threats to growth.

International Consistency

Inevitably, because we loom so large in the world economy, marked improvement in our trade balance will be matched by noticeable deterioration elsewhere. Appropriately, that should take place largely in the major countries with exceptionally large surpluses -- notably Japan and Germany, both of which are now experiencing some decline in real net exports. That process cannot take place smoothly and effectively unless those countries and others are able to maintain a strong momentum of internal demand.

For years, those countries have been dependent for growth mainly on high and rising export surpluses. In both instances, some shift toward domestic demand was apparent in 1986, encouraged partly by some relaxation of monetary policies. That points in the needed direction. Again, the Paris statement provided an indication of the intent of Japan and Germany, along with others, to sustain growth by stimulating domestic demand if necessary.

What is critical from a world perspective is not the precise nature of these measures or their exact timing, but that, at the end of the day, those countries are successful in maintaining a strong momentum of growth even as they absorb more imports from the rest of the world.

Some newly industrialized countries also have clear responsibilities for contributing to a better world balance. Taiwan and Korea, in particular, have or are building external surpluses that are large even by the standards of the traditional industrial powers. Part of that reflects a strong competitive position, but both also maintain a strong wall of protectionist barriers. The very strength of their external positions points -- in the interests of their own citizens as consumers, as well as of world equilibrium -- to the need for more forceful action to increase imports, whether by reducing tariffs, by lifting other trade restrictions or by exchange rate changes.

Success in these efforts, I must emphasize, will not necessarily or primarily be measured by changes in our own bilateral trade vis-a-vis particular countries. An open competitive trading order is by its nature multilateral, and we and others should judge equilibrium in a world-wide context.

In that connection, most of the developing world, already carrying heavy debt burdens, is in no position to revalue currencies or to absorb much higher imports (from the United States or from others) without more or less parallel increases in their exports. In recent years, however, it has been the United States that has, in fact, absorbed the great bulk of what increase in exports Latin America has had -- their exports to Europe and Japan have apparently increased little if at all.

For us to close our markets to them now would assuredly thwart prospects for expansion, and with it the encouraging progress that has been made toward both more open, competitive economies and political democracy. What is needed instead is greater access by those countries to growing markets in Europe and Japan as well as here. The recent changes in exchange rates in the industrial world certainly provide greater incentives for exports of the developing countries to shift to Europe and Japan. At the same time, imports by the developing world from the United States have become much more price competitive than a year or two ago.

<u>The Debt Situation</u>

I cannot neglect emphasizing one further continuing threat to growth and financial stability involving the developing countries. Management of the debt problems of Latin America and some other developing countries is again at a critical stage. The reason is not that progress is absent. To the contrary, most of the heavily indebted countries have been growing -- if for the most part far below their potential -- debt burdens are tending to move lower relative to exports or other measures of capacity to pay, and new financing needs have been reduced. Perhaps most encouraging, there has been definite, if sometimes hesitant, progress toward liberalizing trade, opening markets, and reducing internal economic distortions, with the World Bank playing a particularly helpful role.

At the same time, any failure of the industrialized countries collectively to achieve a satisfactory rate of growth would clearly impair prospects for the developing countries to find the markets they need. More immediately, in recent months, the process of reaching agreement on adequately supportive and timely financing programs, whether by restructuring existing debts or by arranging what new loans are necessary, has conspicuously slowed.

Now, the largest of the debtor countries, Brazil, after a period of strong expansion, large trade surpluses, and greater price stability, is again experiencing pronounced inflationary pressures and economic difficulties. Its suspension of most external interest payments to private creditors underscores the urgency of coming to grips with its internal economic difficulties as well as developing an appropriate financing program. I suspect the very fact that progress has been made over the past five years -- until recently in Brazil as in a number of other countries and most evidently in reducing the exposure of banks relative to capital to something like half of what it was in 1982 -- has had the unfortunate effect of dulling a sense of urgency and cooperation in dealing with the remaining problems. I do not want to deny the progress. But to fail in carrying through on past efforts or in dealing with the new points of strain would plainly jeopardize past successes and threaten new strains on the financial system.

Implications for U.S. Policy

Several key implications of all this for the United States should be clear.

First, the process of restoring external balance requires first of all that we tend to our inescapable responsibilities to deal with our budget deficit. That is not just because we are dangerously dependent on foreign savings but because progress abroad is, as a practical matter, likely to be stymied without constructive leadership from the largest and strongest nation. Should we instead resort to closing our markets, be indifferent to depreciation of our own currency, and permit inflationary forces to regain the upper hand, then there would be no basis for confidence in the United States. Prospects for effective complementary action abroad, or for growth for the world economy, would be dim indeed.

Second, we have to recognize that the needed adjustments will require a relative shift of financial and real resources into internationally competitive industry and away from consumption and federal deficits. Without a sharp rise in overall productivity from the one percent or so rate characteristic of most of the 1970s and 1980s -- and I see no reason to suggest that trend will change abruptly -- the recent rate of increase in consumption is simply unsustainable for long. Instead, more of our growth will need to be reflected in net exports and business investment, and less savings will be available to finance government.

Fortunately, performance with respect to productivity growth and restraint on costs in the key manufacturing sectors has been relatively strong during the period of economic expansion. That reinforces prospects for a stronger competitive position internationally. The challenge will be to maintain that performance in the face of a depreciated currency, higher import prices, and more sizable needs for new investment to meet domestic and export opportunities.

Finally, achieving these goals in the context of sustained growth and reasonable price stability is beyond the capacity of any single policy instrument. Quite obviously, monetary policy will have a critical role to play. In doing so, it has the potential advantage of more flexibility than other policy instruments. But there will also be a heavy premium on maintaining discipline and sound judgment amid potentially conflicting criteria.

Monetary Policy

Looking back, monetary policy has accommodated a relatively rapid growth in the various monetary aggregates for some time; in 1986, the discount rate was reduced four times by a total of 2 percentage points, more or less in line with reductions in market interest rates.

This generous provision of reserves and expansion in money took place in, and appeared justified by, an environment of restrained economic growth and declining inflationary pressures. The latter, to be sure, was dramatically and importantly reinforced by a temporary factor -- the sudden collapse in the price of the world's most important commodity, oil. But, potentially more lasting indicators of inflationary pressure -- the rate of increase in workers' compensation and in prices of some services that respond slowly to changes in the economic environment -- were also trending downward. For much of the year, most commodity prices other than oil, measured in dollars, were falling despite the depreciation of the dollar in the exchange markets. Moreover, the sizable declines in long-term interest rates seemed to reflect some easing of fears of a resurgence of inflationary pressures in the future.

Nonetheless, the possibility of renewed inflation remains of concern both in the markets and within the Federal Reserve. One potential channel for renewed inflationary pressures would be an excessive fall of the dollar in the exchange markets.

Moreover, the continuing rapid expansion of debt throughout the economy -- running far above the rate of economic growth since 1982 -- has raised one warning flag. The implicit dangers should be clear. More leveraging of corporations, aggressive lending to consumers already laboring under heavy debt burdens, and less equity in homes all increase the vulnerability of the economy to economic risk -- to higher interest rates, to recession, or to both. The fact that, after four years of expansion, many measures of credit quality are tending to deteriorate rather than improve, and that too many depository institutions are strained, should be warning enough.

As we look ahead, the Federal Reserve remains highly conscious of the long historical patterns that relate high rates of monetary growth over time to inflation.

In 1987, the effects of the depreciation of the dollar and the rebound in oil prices are very likely to be reflected in somewhat larger increases in consumer prices than last year. What is critical is that such a bulge in prices related to identifiable temporary external developments not be translated into a broad-based cumulative upward movement. As you well know, just such a cumulative inflationary process started in the 1960s and then extended well over a decade into the 1980s. It was eventually brought to an end, but only with great effort and at considerable cost. The scars of that experience remain.

Against that background, participants both in financial markets and in business have persistently been skeptical of prospects for lasting price stability in making investment and pricing decisions. They are bound to be alert and responsive to any sense of adverse change in the underlying inflation trend, with implications for interest rates, exchange rates, and pricing policies. The consequences for the economy would clearly be undesirable.

In effect, neither the internal nor external setting permits thinking of trading off more inflation for more growth. Nor would inflation ease the problem of international adjustment; quite to the contrary, it would both undercut some of our competitive gains and threaten the orderly inflow of funds from abroad. Naturally, in the conduct of monetary policy, we will want to encourage continuing economic expansion. But we also want to see as long an expansion as possible. To that end, the threat of renewed inflation will require continuing caution to avoid excessive increases in money and credit. Clearly, further sizable declines in the federal budget deficit will make our job in the Federal Reserve easier.

Concluding Comments

In sum, we face, at one and the same time, most difficult and most promising economic circumstances.

They are difficult because there are obvious distortions and imbalances within our economy and internationally. Unless dealt with forcibly and effectively, those imbalances will impair both growth and price stability -- and the adverse implications will be amplified by the effects on other countries. Moreover, those imbalances will not yield to any single instrument of policy, however wisely conducted. Instead, what is required is complementary actions here and abroad -- on budgets, on monetary policies, and on maintaining appropriate exchange rates and an open trading order.

I know none of that is easy. Many countries are involved, and all of them have tough political decisions to make. Nor are the key decisions entirely in the hands of governmental authorities. American industry, in particular, has the challenge to build upon the efforts of recent years toward effective control of costs and greater efficiency, and to seek out and exploit the greater market opportunities that exist today.

From one point of view, it may seem like a lot to ask. But equally, there is a lot to be gained.

We already have achieved a long economic expansion. We have managed to combine that with progress toward price stability -- and that progress has made possible lower interest rates. Financial markets more generally reflect renewed confidence. And the broad outline of policies that can preserve and extend those gains are by now well known.

To fail to act upon those policies -- to instead retreat into protectionism, to relax on inflation, to fail to deal with the deficit -- may in some ways appear to be the course of least resistance. But those are also precisely the ways by which we would turn our back to the bright promise before us.

It is only a concerted effort here and abroad that will extend and reinforce the economic expansion, consolidate the progress toward price stability, and provide the international environment in which all countries can prosper.

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