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Testimony by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance, and Urban Affairs

House of Representatives

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Mr. Chairman and Members of the Committee:

I appreciate this, my last, opportunity to appear before you as Chairman of the Federal Reserve Board in connection with the semi-annual review of monetary policy. You have the official Report of the Board of Governors before you and I will be blessedly brief in touching upon some of the main points.

As you know, the economy has continued to grow this year, carrying the expansion well into its fifth year. At the same time, however, the inflation rate has accelerated appreciably relative to the low rate prevailing in 1986.

A change in that direction had been widely anticipated in response to the rebound in oil prices and the depreciation of the dollar. Nevertheless, the size and pervasiveness of the price increases -- which have included many non-energy materials as well as services -- affected the psychology and expectations in financial markets, particularly in April and early May. Recurrent concerns about the dollar internationally also at times affected the mood of domestic markets, and interest rates rose rather sharply for a time.

Through the early part of the year, Federal Reserve operations placed minimal pressure on bank reserve positions. As reported earlier, however, beginning in late April definite but modest steps were taken to increase reserve pressures somewhat. Perceptions of that action appeared to help calm concerns about the future course of the dollar and inflation.

Most interest rates, long- and short-term, have retraced part of the earlier rise. However, long-term interest rates and prices of sensitive commodities, some of which had been deeply depressed, remain well above their levels of earlier this year.

The approach of the Federal Reserve toward the provision of reserves has not changed since May. However, growth in the various monetary aggregates slowed further in the second quarter. A reduction in the rate of growth of those aggregates from the relatively high levels of 1986 had been both anticipated and desired by the Federal Open Market Committee, as reported to you in February. However, it is also true that, with institutional and market developments importantly affecting the relationships between the various measures of money and the variables we ultimately care about, judgments about the appropriate growth of the aggregates have become both more difficult and more dependent on prevailing economic and market circumstances.

For that reason, the Committee did not set forth a particular target range for M1 this year in February. That judgment was reaffirmed at the meeting earlier this month. M2 is currently running below, and M3 around, the lower ends of their 5-1/2 to 8-1/2 percent ranges established in February. The Committee decided not to change those ranges for 1987. In doing so, however, there was agreement that, depending on further evidence with respect to emerging trends in economic activity, inflation, and domestic and international financial markets, actual growth around the lower ends of those ranges may well remain appropriate.

In judging appropriate monetary growth during the course of the year, or from year to year, account needs to be taken of the apparent increase in the sensitivity of demands for money, and for money-like assets, to absolute and relative changes in market interest rates. Interest rates administered by institutions, especially those on transactions accounts, tend to lag market rates both when interest rates are rising and when they are falling (of course, no explicit interest can be paid on demand deposits). At the same time, the cost and effort involved in shifting funds between types of accounts, or into and out of market instruments, has greatly diminished. Experience suggests that, as a result of these factors, demand deposits, NOW accounts, and money market deposit accounts all tend to grow relatively slowly, if at all, when market rates are rising (as during the second quarter) but much faster than normally as market rates fall, as during 1985 and 1986. Those differences in growth rates in money will tend to be reflected in inverse movements in the velocity (that is, the measured rate of turnover) of money rather than commensurate changes in economic activity or prices.

That sensitivity of velocity to changes in interest rates makes it more difficult to judge the appropriate rate of monetary growth -- particularly over periods as short as a quarter or a year -- and impossible without reference to the stream of available evidence on economic activity, prices, and other factors. This year, too, concerns about the international performance of the dollar have at times had a significant bearing on operational decisions. Specifically, the tightening of reserve availability in the spring was related in substantial part to the desirability, in the light of the substantial cumulative depreciation over the previous two years and other economic policy undertakings here and abroad, of maintaining reasonable stability in the external value of the dollar. That judgment is, as you know, shared with the Administration and the finance ministers and central bank governors of other leading industrialized countries.

Looking ahead to 1988, the Open Market Committee decided tentatively to reduce the target ranges for M2 and M3 by 1/2 percent to 5-8 percent. While recognizing the inevitable range of uncertainty I referred to earlier, some reduction in the target ranges clearly appeared appropriate in recognition of the importance of assuring that the temporary bulge in price increases foreseen for this year not become a base for a renewed inflationary process. The appropriate range for 1988 will, of course, again be reviewed with care at the start of the year.

More broadly, policy has to be judged against progress toward the more basic goals of growth and stability -- and it seems to me fatuous to think the first could long be sustained without the latter. At the same time, now and for some years ahead, we will need to work to narrow and ultimately correct the large imbalances in our internal and external economic positions -- adjustments that necessarily have implications for the policies and prospects of other countries as well. What is at issue is whether we can make those necessary adjustments while sustaining progress toward the broader goals.

In some areas, developments in the past six months have been strongly encouraging in that respect.

-- The evidence by now is pretty clear that, in real terms, our trade balance is improving, even in the face of continuing sluggish growth, high unemployment and excess capacity abroad.

While growth in domestic consumption has slowed -- one essential part of the adjustment process -- the expansion of domestic output and employment has been well maintained, and unemployment, at close to 6 percent, has dropped to the lowest level in this decade. Manufacturing has picked up and prospects for business investment may be improving. Helped by some large unanticipated capital gains tax receipts, this year's budget deficit will apparently be driven even below earlier expectations, and thus very substantially below the fiscal 1986 level. Internationally, leading nations are not only agreed upon the desirability of greater exchange rate stability but appear to be working more effectively to that end.

In another area demanding a high level of international cooperation, the basic approach for dealing with the international debt problems has continued to be implemented with substantial success despite doubts and challenges by some.

Of central importance, there has been continuing evidence of restraint and discipline on costs and wages in much of American industry, offering the prospect of lower rates of inflation in the months ahead. Over time, that must be an absolutely essential element in maintaining our international competitivness as well as in restoring domestic stability after the bulge in prices this year.

At the same time, it would be nonsense for me to claim that all is safely and securely on path. The remaining risks and problems are apparent.

Even the otherwise satisfying fall in the unemployment rate this year implicitly has a discouraging aspect. Outside of manufacturing, the statistics suggest productivity growth is quite dismal -- so slow, in fact, that I cannot dismiss the thought that the reported statistics may partly reflect measurement error.

But no error of measurement can entirely explain away that our private saving, in historical or in international context, remains so low, or that our federal deficit remains so large, or that we, the putative leader of the western world, are so dependent on other people's capital. Despite the better news on this year's federal deficit, some projections of future deficits assuming current programs are being raised rather than reduced and the political impasse over doing something about it apparently remains. In the circumstances, the Gramm-Rudman-Hollings targets are threatening to become pie in the sky.

The already slow growth in other industrialized countries appears to have slowed further this year, working against the adjustments needed in trade and current account positions among Japan, Western Europe and the United States. And, in that environment the dangers of protectionist trade legislation and a breakdown in the servicing of international debts are enlarged.

For all those reasons and more, my very able successor, and the Federal Reserve generally, will have challenge aplenty.

But, I, as I have spelled out earlier, would like to think there is something upon which to build as well.

Finally, Mr. Chairman, I would like to acknowledge specifically the usefulness from my standpoint of these regular semi-annual hearings on monetary policy.

You and I are both conscious of the special position of the Federal Reserve System within the overall framework of government. The long terms of members of the Board of Governors, the participation of the Regional Federal Reserve Banks in the policy process, our budgetary autonomy, and the professionalism of our staff are all designed to provide some insulation, in deciding upon money creation, against partisan or passing political pressures.

In our system of government, however, insulation cannot be equated to isolation, and particularly isolation from reporting and accountability to the Congress and to the public.

These hearings are an important element in that discipline. I have welcomed the opportunity they have provided for us to consult with the Congress, and to explain our purposes, our approaches, and our problems in dealing with a complicated, changing economic environment. And I want to express my appreciation as well for the many courtesies you have extended me personally over these past eight years as we have worked together to foster economic stability and growth.

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