Testimony by

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Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you this morning to discuss economic developments within the Fourth District of the Federal Reserve System and to offer my views on monetary policy. I find that approaching the issue of monetary policy from the perspective of economic conditions within our region is particularly informative. I make this statement for two reasons. First, the extensive restructuring within the four states that comprise the Fourth District--Ohio, and parts of Kentucky, Pennsylvania, and West Virginia--provides important insights into the experience of the national economy during the last several years. Second, the gains that this region achieved because of these adjustments were aided to a large extent by the stable-price policies of the Federal Reserve System during that period. As I will discuss in my testimony, these issues are important for understanding the current and future course of the national economy.

In many ways, the Fourth District's performance during the last decade foreshadowed that of the national economy during the last several years. While the national economy saw extraordinary growth since 1980, the Midwest's expansion was much more subdued. Employment within the Fourth District states grew 9 percent from 1980 through 1992. During the same period, employment in the national economy, driven by the bicoastal boom, expanded 21 percent. The nationwide increase was sufficient to absorb both an enormous number of baby boomers reaching working age and the steady rise in women's participation in the work force.

While much of the rest of the nation expanded, the Midwest was forced to focus on restructuring--a process that had been under way for some time. Although restructuring was a painful experience for many people, businesses, and banks in the District, it was necessary to restore the competitiveness of its industries. On the negative side, in 1980-82, we saw the devastating results of the worst recession to hit this region since the 1930s: basic industries scaling back or shutting down, whole communities cut off from their economic mainstay, workers displaced and discouraged. On the positive side and more recently, the beneficial results of this ongoing process have become more evident in the phoenix-like rise by some industries to become much more vibrant and competitive forces in the local, national, and international economy. Newspapers and magazine articles have heralded this recent resurgence as the renaissance of manufacturing. The Rust Belt has indeed begun to regain some of its old luster.

Through improvements in productivity and a more balanced industrial mix, our region is now poised for future growth. The growth will be uneven, as some parts of the District are much stronger than others. Clearly, restructuring will continue, both within the Fourth District and across the United States. But I have no doubts that a strong foundation is in place for a healthy and sustainable expansion for the foreseeable future. Our relatively buoyant regional economy during the past two years and our increased presence in foreign markets attest to the gains that we have made. The central questions will be about the pace and durability of the expansion, not about contraction.

During the 1980s, the Midwest faced a host of market imbalances, not unlike the problems that confront other parts of the country today. The region was able to work through these problems, not because of government action, but because market forces led inefficient industries to invest in new technologies or simply to close down, workers to invest in new skills, employees and management to seek more flexible and innovative relationships, and entrepreneurs to find and develop promising new opportunities.

Government does have an important role, however. It is to establish an environment of competition and long-run stability so that markets can allocate resources to their most valued uses. The restructuring that took place in the Fourth District was aided immensely by the reduction in inflation and by the acceptance that this vigilance would continue in the future. Maintaining this commitment will facilitate the restructuring that this and other regions of the country are currently experiencing.

As I have stated on many occasions, monetary policy can best promote sustainable long-run economic growth and rising standards of living by stabilizing the aggregate price level, by creating a climate of confidence about the outlook for price stability, and by avoiding being a source of economic disturbances through unexpected changes in monetary policy. The extent to which this current recovery is at risk depends importantly on monetary policy. Deviating from a steady and determined pursuit of our longer-run objectives in response to short-term events could jeopardize our progress.

My prepared comments discuss in some detail the restructuring and current conditions of the Fourth District and my views on the most effective monetary policy for maximizing long-run output and raising the standard of living of all of us.

Fourth District Restructuring

The byword for this region over the last decade has been *restructuring*--replacement of old technologies with new ones, innovation in business practices, scaling back of less efficient industries and expansion of more competitive ones, and absorption of excess commercial real estate. The restructuring, although difficult and painful, was necessary to improve efficiency and restore competitiveness. The success of these adjustments can be illustrated by comparing the employment pattern during the last recession with that of previous ones. In the six downturns prior to this most recent contraction, the Fourth District states experienced employment declines two to four times as large as that of the nation. In the past recession, the drop was less than half as large as the national decline. Furthermore, during the 1990s, the region's unemployment rate generally has been lower than the national rate.

The restructuring led to four basic changes, which have strengthened this economy. First, companies, particularly in the manufacturing sector, have improved productivity. For example, manufacturing output in Ohio has doubled since 1982, while the number of factory jobs has remained roughly the same. With each worker producing considerably more output, we now have a leaner, more competitive manufacturing sector, but one that does not generate as many jobs as it once did. If this trend continues, as I expect, employment will move up as productivity levels increase, but in all probability, more slowly than past experience would suggest.

Second, the industrial mix of the economy is more balanced, relying less on the cyclically sensitive durable-goods-producing sectors. Third, the region has increased its participation in export markets. Through greater competitiveness, improved product quality, and a deliberate effort by businesses to meet foreign specifications and to cater to foreign tastes, local businesses have gained an increasing share of many export markets. This is one reason why the region was more resilient in the early 1990s downturn.

Finally, the region has a strong banking sector. Sound and efficient banks are better able to provide financing to creditworthy borrowers, which bolsters regional growth. Our banks are among the strongest in the country. By implementing prudent management strategies and avoiding the construction boom-and-bust cycle of the past decade, Fourth District banks have outperformed their national counterparts. In the first nine months of 1992, return on assets of District banks was higher than the national average (1.37 percent versus 0.95 percent) and net loan losses as a share of total loans was lower (0.95 percent versus 1.15 percent). In addition, as of September 30, 1992, noncurrent loans as a share of total loans of District banks was lower (1.87 percent versus 3.34 percent), and the ratio of book equity to total assets was somewhat higher (7.77 percent versus 7.39 percent).

As a result of these developments, our region is now in much better shape than previously. I am encouraged by my conversations with businesspeople and bankers around the District, who tell me of significant improvements in some of our key industries.

The view and the attitude expressed are overwhelmingly forward looking, and this gives me reason to believe that the trend will continue. Capital goods producers generally anticipate continued and broadening strength in orders and production this quarter from last. Auto manufacturers tell us that they anticipate a healthy improvement in U.S. motor vehicle sales in early 1993. With dealer inventories generally under control, increased vehicle demand has led to rising factory orders. Steel producers in the District report that the surge in new orders since late last year, from auto and appliance producers, continued in February and has led to rising backlogs of unfilled orders and stretching out of deliveries. Some flat-rolled-steel producers report that their order books for the first half of 1993 are virtually at capacity.

Despite production gains, most of the people we have talked to are very cautious about near-term hiring plans. Employment gains simply have not matched output growth in most industries. For example, while manufacturers of industrial controls, truck components, and steel note a high level of operations in recent months, they are resorting primarily to outsourcing, extra shifts, and overtime to accommodate output growth instead of adding workers. In the auto industry, however, most employees on temporary layoff have been recalled, and some facilities are hiring additional workers, as many assembly plants have increased their production schedules. But we must not forget that the U.S. auto industry is still adapting to change and working through large excess capacity.

Service-sector employment growth also has been relatively anemic. For instance, retailers report that they, like manufacturers, are experiencing intense competitive pressures to cut costs and have relied upon labor-saving technology and management techniques, such as tighter inventory control, to accomplish that goal. Employment growth has been steady in the health care industry, which has emerged as one of the largest sectors in both Cleveland and Pittsburgh--two of the largest cities in our District.

Sluggish jobs growth in the Fourth District is part of a national phenomenon. The interesting question is whether employment will pick up enough to offset the slow growth of the last few years or whether it will remain moderate, growing along a permanently lower trend. Certainly, last month's payroll employment figures are encouraging.

In my mind, there are several reasons why employment has not been increasing faster in this expansion. A large amount of sectoral reallocation of labor is taking place, not just in my district, but across the country. For example, displaced defense workers are having to retrain for employment in other sectors. This process is neither painless nor instantaneous, but as workers become absorbed in new jobs, we expect employment to return to previous trends. Productivity is on the rise, some of which is due to new technologies. As workers are reabsorbed into more competitive industries and these industries expand in domestic and world markets, we might expect a return to normal growth along a higher trend.

There may be some additional factors that discourage firms from hiring workers. One factor is the steady rise in the cost of medical coverage for employees. Firms often find it cheaper to pay overtime to existing workers than to take on more workers. Another factor is the mounting regulation facing businesses. Even legislation designed to achieve useful purposes can sometimes create unintended side effects. For instance, businesspeople have viewed several pieces of legislation enacted during the past several years as adding significantly to payroll costs. While businesses may not yet fully understand the actual costs of such regulations, they may very well be reluctant to do any significant hiring until these costs become more clear. To the extent that recent slow employment growth is due to permanently higher labor costs, we may not recover all those jobs lost in the last few years.

While signs of a faster-paced and sustainable expansion are improving, I still have some concerns. Unless monetary policy is conducted in a manner consistent with price stability, the overall expansion could remain anemic.

Monetary Policy

Monetary policy has played an important role in the restructuring that is still going on in the nation and, to a lesser--but still important--degree, in the Fourth District. No doubt the need for some of this restructuring has its roots in mistakes that were made in the 1970s. One of the problems with inflation is that it obscures price signals and causes both businesses and households to make mistakes that can take years, even decades, to remedy. Price level uncertainty distorts the economic information contained in market-generated prices. It can induce people to save too much or too little, to invest in the wrong assets, and to be cynical about their government. And, when inflation surprises are curtailed, as the public inevitably demands, the resource allocation mistakes become painfully apparent.

Unfortunately, the role of monetary policy in affecting output is often misunderstood. It is important to remember what policy can and cannot do. It cannot create capital stock, train workers, or improve technology. Nor can it produce real goods and services, create employment, permanently lower the unemployment rate, or peg or permanently lower the real interest rate. This is not to say that there is no role for monetary policy. But instead of manipulating aggregate demand in a futile attempt to achieve an unattainable employment objective, monetary policy should focus on providing the conditions that lead to maximum sustainable growth.

In the not-too-distant past, prices were destabilized by policymakers who believed in a tradeoff between price stability and full employment. That dichotomy was false.

Monetary policy affects only the efficiency with which real productive resources are used. In the past, monetary policy often kept the economy from reaching its potential because the policy was not made consistently from one year to the next. When short-run attempts to stimulate the economy through monetary policy have led to inflation, the economy operated less efficiently and people ended up working just as hard but producing less.

What monetary policy can do to promote long-run economic efficiency is to stabilize the aggregate price level and to create a climate of confidence about the outlook for price stability. Confidence in price level stability would raise living standards because it would enable businesspeople, investors, workers, and consumers to make wiser plans for consuming, saving, and investing. Plans made on the basis of inaccurate assumptions about future prices are often inefficient.

Price level stability would eliminate the incentives people have to employ resources to hedge against inflation. A firm commitment to price stability would free these resources for more productive uses. Moreover, it would foster the stability of banks and the financial system. When investments are made on the basis of price projections that prove to be wrong, the lenders that provided the funds for those projects are often hurt along with the investors.

How can price stability best be achieved? There has been some discussion about the need to go beyond monetary targets in the Humphrey-Hawkins process. I could not agree more. We need a commitment to an explicit long-run price objective so that the Federal Reserve can use annual monetary targets more effectively. The question is whether monetary targeting can achieve price stability in the absence of an explicit commitment to a price objective. Perhaps so, but not as easily in my view, and at a considerably greater cost. An explicit commitment to price stability is an essential operational element that is missing from today's policy process. Given the apparent inability of policymakers to agree on an explicit price objective, the next best thing the Fed can do is to keep money supply growth within specified target ranges that are consistent, over longer periods of time, with price stability.

But which money supply: M2, or a narrow measure like M1? M1, which includes currency and transactions balances, grew very rapidly last year. Households and businesses added considerably to such balances relative to their income and as a share of total assets. In economists' jargon, the velocity--rate of turnover--of such balances declined. At the same time, the small time deposits included in the broad measure of money, M2 (which includes M1 as well as small time deposits and savings balances) fell sharply and are continuing to decline. Households have reduced their holdings of these instruments in absolute terms, as well as relative to their income and as a share of their total assets. As a result, the velocity of this M2 component rose substantially and by a surprisingly large amount relative to past experience.

For a policymaker, the challenge is to analyze these conflicting signals and attempt to anticipate future trends in order to conduct reserve supplying operations that, over time, are consistent with achieving maximum sustainable growth in a stable price environment. We have spent considerable time and resources trying to understand the monetary data, and still we are uncertain. While this is discouraging, it is not unusual. We should not forget that all economic data represent attempts to match aspects of the real world with theoretical concepts. Just as there is a wide gap between the theoretical concept of output and the real-world measure of output, there is also a gap between a theoretical concept of money and the targeted aggregates.

Nevertheless, in the real world, we must make prudent judgments about how much weight to give to various measures of money. In my opinion, the best we can do today is to choose monetary targets that we think are consistent with long-term price stability and try to maintain them. When these targets need to be adjusted in order to achieve and maintain price stability, we should adjust them. Such a strategy automatically avoids aggravating the fluctuations in economic activity. Should the economy go into recession, the money supply would tend to fall below target, unless the Fed supplied additional reserves. Conversely, should the economy expand very rapidly, the money supply would tend to go above target unless the growth of reserves is restrained. If the long-run inflation objective is known, and credibility is maintained, then the adjustments necessary to achieve price stability can be made much more effectively.

Of course, other factors affect the monetary aggregates, including interest-rate differentials, the resolution of the S&L crisis, and the evolution of liquid mutual funds. Although these factors have been exerting an unusually large effect on money supply growth, the announced target ranges for the broad aggregate (M2) are wide enough to accommodate even this extreme behavior.

What is the alternative? Some have argued that policy judgments would be better made if the Fed ignored monetary aggregates and instead looked at the real economy. I cannot agree. In view of the dramatic economic restructuring taking place today--technological developments, defense cuts, commercial real estate problems, to name just a few--we cannot have any more confidence in our estimates of potential output than we have in our estimates of demand for a specific monetary aggregate.

Furthermore, we have no direct linkage between monetary policy actions and either actual or potential output. Let me say once again that although we may be uncertain about how to interpret the disparate behavior of the monetary aggregates today, this uncertainty is no greater than the uncertainty that always exists about potential output.

What does all this mean for monetary policy? One of the biggest obstacles to sustained economic growth during the year or so has been the lack of credibility of the long-run commitment to price stability. While inflation has moved down, the public has persisted in its belief that future inflation will be higher. Long-term interest rates have declined, but are still substantially above the levels that would be consistent with price stability. This belief is reflected in consumer surveys and is manifested in the extraordinary steepness of the yield curve and in such behavior as the record number of homeowners who have refinanced mortgages. The extensive business balance-sheet restructuring, which is still going on, also suggests expectations that future borrowing costs will be higher as inflation accelerates.

The credibility of the Fed's goal to achieve price stability has been undermined to some extent by the belief of analysts and policymakers that the Federal Reserve, through aggressive monetary policy, could move the economy to a sustainable, faster long-run growth trend. As Chairman Greenspan indicated to you last month in his Humphrey-Hawkins testimony, these mistaken beliefs have left us with an economy in which private markets quickly embed even the expectation of stimulative monetary policy into higher inflation expectations and nominal bond yields.

To lock in the hard-won gains made against inflation in the 1980s and extend them well into the 1990s, the challenge is to find a way for the Federal Reserve to make a credible long-term commitment to an explicit goal for price stability. Only by doing this can we combat the 1970s legacy of heightened market sensitivity to short-run monetary policy actions, reduce long-term nominal interest rates by another 2 or 3 percentage points, and create an environment in which inflation fears no longer retard the efficient functioning of the economy.