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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance, and Urban Affairs

U S House of Representatives

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I am pleased to appear before this committee to discuss the current economic situation and the outlook for 1989. As you know, the Federal Reserve will submit its semiannual report on monetary policy to the Congress next month. That report will cover in detail the FOMC's policy targets for 1989, as well as our expectations for real growth and inflation. Today, I would like to focus on some of the broader considerations bearing on our economic prospects.

The overall record shows 1988 to have been another year of progress for the U.S. economy. Setting aside the effects on aggregate output of last summer's drought, real GNP appears to have risen more than 3 percent over the course of the year. That pace was considerably faster than was expected by many analysts at the start of the year, and it came on the heels of a strong 5 percent GNP increase in 1987. Especially encouraging in terms of the prospects for sustained expansion is that these surprising gains have been achieved without a flare-up of inflation. Prices have accelerated only slightly, with increases in most broad indexes holding in the range of 4 to 4-1/2 percent.

As we enter 1989, there are few signs of any significant impediments to continued expansion. Business cycle history tells us some places to look for danger signals. One of them is excessive accumulation of inventories, at present, overhangs of stocks are rather isolated and manageable. Another is overbuilding of capacity, while there clearly are a good many empty office buildings around the country, industrial capacity is relatively fully utilized--indeed, tight in some industries. Still another is out-of-control costs and inadequate profit margins, again, there appear to be no widespread problems.

However, this is not to say that we have little reason for concern. Resource utilization has risen to levels that at numerous times in the past have been associated with a worsening of inflation. If growth were to continue indefinitely at the recent pace, the concomitant tightening of supply conditions for labor and materials would risk a serious intensification of inflationary pressures at some not too distant point in the future.

How fast the economy can now grow without a significant pickup in inflation is obviously a key question. The answer depends, of course, on the amount of slack in labor markets and in industry and on prospects for the growth of labor and capital resources and of technological efficiency. Inflation in the longer term is essentially a monetary phenomenon. But excess pressures on productive resources have usually been the major trigger engendering financial tensions that too often have been relieved through inflationary monetary expansion. Unfortunately, such pressures can be extremely hard to discern in a timely way. Economic relationships are complex and difficult to pin down; the lags between changes in resource utilization and in prices can be long, and the translation into credit and financial excess inexact. Moreover, conventional measures of resource utilization may not be sufficiently sensitive to the increasing openness of the U.S. economy in recent years and to other changes in the economic structure. Nonetheless, a careful examination of the historical experience--in conjunction with a knowledge of demographic trends and other long-run developments--provides ample evidence of where the risks lie.

The labor market is showing clear signs of tightening. Gains in employment exceeded 2 million last year, according to the Census survey of households, this outstripped the growth in the labor force, and the unemployment rate fell to its lowest levels since the 1970s. However, the demographic composition of the work force has changed considerably since the 1970s. And workers now seem to be placing greater emphasis on job preservation as opposed to bigger wage gains, while businesses strive to contain costs and to enhance competitiveness. Accordingly, the wage pressures associated with a 5-1/4 percent jobless rate today are less than they would have been 10 or 15 years ago. It also is unlikely that a few tenths of a percentage point up or down on the unemployment rate would change the inflation outlook dramatically. Nonetheless, the available evidence points to a high probability of stepped-up wage pressures should unemployment decline significantly further.

In part, that assessment reflects the fact that unemployment now is well within the range of 4-1/2 to 6-1/2 percent that encompasses most estimates of the "natural rate" of unemployment. The concept of a natural rate of unemployment, that is, a rate consistent with stable inflation over the long run, is a useful notion for empirical studies of the relationship between labor market tightness and inflation. Unemployment below the natural rate presumably would provide sustained impetus to inflation, while unemployment above the natural rate would tend toward disinflation. Any figure for the natural rate should be viewed cautiously, given the uncertainties and the complexity of the economic relationships involved, indeed, the most recent estimates are

perceptibly lower than many analysts thought likely only a few years ago

Nonetheless, increases in compensation--although volatile from quarter to quarter--picked up roughly a percentage point last year, to the range of 4-1/2 to 5 percent. Pay gains in many occupations and regions of the country where labor demand has been especially strong have been somewhat greater. In the Northeast, for example, hourly compensation increased nearly 5-1/2 percent over the year ending last September. Reports of labor shortages and wage pressures are widespread in some regions, and there is some fear that the tenor of wage negotiations may shift in a direction inimical to cost restraint.

Measures of industrial supply conditions are more ambiguous, but on the whole also point to a tightening. Utilization rates for plant and equipment, as in the labor market, have moved up sharply over the past few years. Capacity utilization in manufacturing, after hovering around 80 percent from 1984 to mid-1987, has climbed to 84-1/2 percent. Some industries, including steel, paper, and chemicals, have been operating flat out, or close to it.

The conventional measures, however, may well overstate the degree of price pressure. Capacity is a somewhat elusive concept. For example, facilities can be moved in and out of use or put on different operating schedules in response to fluctuations in demand and prices. Moreover, measures of domestic capacity do not take account of the availability of materials and supplies from abroad--a factor of some importance in our increasingly open economy. Indeed, the information compiled monthly by the National Association of Purchasing Management

suggests that what may be called "deliverability" was diminishing only moderately at year-end, after marked deterioration in 1987 and early 1988. Vendors were missing their schedules less often, while average lead times for orders of production materials were no longer than they were a year earlier.

Our estimates of aggregate production capabilities clearly are imprecise. Moreover, labor markets and industrial facilities may well be flexible enough to allow us to operate for some time at higher levels of resource utilization without a visible deterioration in inflation. But there is little doubt that margins of slack have been reduced. The risk of greater inflation could be appreciable if real GNP continued to increase at recent rates over the next several years.

With most of the slack having been taken up, our growth will tend to be limited by the rate at which our productive capacity expands. Most estimates place the growth in productive capacity--or long-term potential GNP--in the area of 2-1/2 to 3 percent per year. Growth of the labor force has dropped markedly since the 1970s, given the trends in the working-age population, in participation rates, and in the average workweek, such growth is likely to remain relatively slow in coming years. And while one can hope for some offset from better labor productivity performance, the improvements we've seen to date in the economy-wide data have not been dramatic. Gains in nonfarm business productivity have picked up somewhat in the 1980s, but--at only about 1-1/4 percent per year--they fall far short of those recorded in the 1950s and '60s. In part, the disappointing productivity performance reflects the low level of net investment.

To be sure, we have not had great success in forecasting intermediate shifts in productivity in years past. It is possible that forces not now visible could impart a significant upward push to productivity. This could boost potential economic growth beyond 3 percent per year. However, a policy that assumes such outcomes risks significant inflationary imbalances. I think it is wiser to have "money in the bank before we spend it," so to speak.

Containing the pressures on labor and capital resources--while continuing to reduce our external imbalance--will require a slowing in domestic demand. Such an outcome will be facilitated to the extent that the federal budget deficit is reduced. With the Gramm-Rudman-Hollings procedures providing some discipline on spending decisions, the budget looks to be a mildly restraining influence on domestic demand this year. But it is crucial that further steps be taken in support of a long-term policy of reducing budget deficits and the associated claims on the nation's saving.

Lower budget deficits will pay off over the longer run. They will free up domestic saving to finance investment that embodies the most up-to-date technology. Therein lies a major hope for attaining the productivity gains so crucial to growth in potential GNP. In the 1980s, a large inflow of capital from abroad has made it possible to finance both the federal budget deficit and a high level of gross private investment without untenable pressures on credit markets. However, a country cannot depend forever upon foreign saving, at some point we will have to rely more fully on our own resources. The paucity of aggregate domestic saving in recent years has been exacerbated by a sharp fall in

private saving, and we cannot count on a major reversal of that trend. We have endeavored in the past few decades to implement tax policies to augment household and business saving; by all accounts, they have met with only limited success. Accordingly, the surest way to overcome the shortage of domestic saving is through sizable reductions in budget deficits.

Monetary policy also will bear importantly on our economic prospects, and I will be reporting to the Congress next month on the Federal Reserve's plans for monetary policy in 1989. Let me comment, however, on the notion I hear all too frequently that current rates of inflation are acceptable to the Federal Reserve. Fundamentally, our strategy continues to be centered on moving toward, and ultimately reaching, stable prices, that is, price levels sufficiently stable so that expectations of change do not become major factors in key economic decisions. Current inflation rates, by that criterion, clearly are too high and must be brought down. Progress toward that goal in 1988 was inhibited by the lagged effects of the sharp decline in the dollar over the 1985-87 period and by the drought-induced flare-up in food prices. However, the dollar now is at levels where U.S. industry is quite competitive. Of course, we recognize that achieving the joint goals of growth and price stability will require persistence and patience. To the extent that labor and management perceive our commitment, the dynamics of the wage-price process will work in our favor.

The pursuit of such a strategy on the part of the Federal Reserve embodies an acute awareness of the great cost to our economy and society should a more intense inflationary process become entrenched.

The experience of the past two decades vividly illustrates the problems that arise when accelerating prices and wages have to be countered later by severely restrictive policies. There are unavoidable adverse implications for production and employment, as well as for the financial health of many individuals and businesses. For that reason, it is our judgment--as I indicated to the Congress last July--that the long-run costs of a return to higher inflation, and the risks of this occurring under current circumstances, are sufficiently great that Federal Reserve policy at this juncture might well be advised to err more on the side of restrictiveness than of stimulus.

Let me conclude by saying that I view our economic prospects in 1989 and beyond as favorable, but that such an outcome is by no means assured. I have spoken at length of the risk of rising inflation when labor and product markets are operating at or near full capacity. The deficits in the federal budget and in our external accounts also are serious problems that must be dealt with. However, if we remain attentive to the course of events and take prudent actions on a timely basis, I am optimistic that we can make further progress toward the objectives of full employment and price stability.