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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

of the

U.S. Senate

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Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss with you recent monetary policy and our plans for the future. You have received our formal report to the Congress This morning, I would like to summarize the important points of that report and to place monetary policy in the context of the overall economic and financial situation.

Economic and Monetary Developments in 1988

Last year was a challenging one for monetary policy Early in the year, uncertainties remained about the impact of the October 1987 worldwide stock market break on the economic expansion and financial system. Given these risks, the Federal Reserve increased the availability of bank reserves slightly further, adding to the easing put in place immediately following October 19; at the same time we monitored financial and economic indicators closely for any signs that the economic expansion was faltering

Gradually, however, it became clear that the economic expansion remained well on track and that market confidence was on the mend Spending was robust, and dwindling margins of unused resources as employment and output registered sizable gains indicated that the balance of risks was shifting in the direction of higher inflation Consequently, the FOMC applied increased restraint to reserve positions in a series of steps beginning in the spring of 1988 and extending to the current period. In addition, the discount rate was raised from 6 to 6-1/2 percent in August

The policy restraint led to an appreciable rise in short-term market interest rates beginning in the spring of 1988. Growth of money moderated over the year as rates on deposits lagged the rise in market interest rates. M2 and M3, which were near the upper ends of their target ranges early in the year, slowed considerably in subsequent months and finished the year around the middle of their 4 to 8 percent annual target ranges Growth of M1 also was restrained by higher interest rates, slowing to about 4 percent, while the monetary base grew only a bit less rapidly than in 1987, as currency continued to expand at a strong pace. Thus, in both 1987 and 1988, most money measures grew appreciably more slowly than they had in many years. This more moderate pace of monetary expansion has been a necessary aspect of a monetary policy designed to contain inflation and promote price stability and economic growth over time

Despite tightening money markets, longer-term interest rates have been remarkably stable Yields on Treasury bonds, for example, remained in a fairly narrow range around 9 percent for most of the year and have continued in that range so far in 1989 Moreover, the stock market recovered relatively steadily over the year and into

1989. The performance of the bond and stock markets in the face of rising short-term rates seemed to stem from expectations of continued relatively balanced economic expansion in the United States with inflation pressures not likely to intensify U S. investments looked attractive under these circumstances, and the dollar's average value against major foreign currencies recovered from the late 1987 plunge and was relatively stable over the course of the year.

The optimism of domestic and foreign investors evident in financial markets reflected the solid performance of the economy and prospects for its continuation. Our GNP expanded by around 3-1/4 percent in 1988, adjusted for crop losses caused by the drought. Over the year, payroll employment rose by 3 7 million Since the economic expansion began in late 1982, employment in the United States has increased by more than 17 million people, pushing the unemployment rate below 5-1/2 percent, its lowest level since the mid-1970s Employment gains in 1987 and 1988 were strong in nearly every major sector of the American economy, including manufacturing, construction, trade, and services. Although in 1988 farmers suffered one of their worst crop losses in this century, the situation in agriculture remains fundamentally much improved from that earlier in the 1980s. Industrial production in manufacturing rose 5-1/2 percent, bringing average capacity utilization to the highest level since the late 1970s. Some industries that had been hit especially hard by the recession of 1981-82 and by the erosion of international competitiveness owing to the rise in the value of the dollar now are considerably improved. Quite a few firms in those industries are operating essentially flat out and experiencing notable profit improvement.

However, last year's economic performance had some disappointing features. The federal budget deficit remained high and our national saving low This contributed to a continued large current account and trade deficit By keeping pressure on interest rates, the low rate of saving also was a factor behind the performance of business fixed investment last year. Investment slowed from 1987, especially in the second half of the year, even in the face of relatively rapid expansion of production and high levels of capacity utilization

In addition, overall inflation, in the area of 4 to 4-1/2 percent, during 1988 was a little above the general range in which it had fluctuated in the mid 1980s The drought boosted food prices, adding somewhat to inflation last year, but this was largely offset by a leveling off of energy prices. Prices of other consumer goods and services accelerated a bit. This acceleration is troubling, especially with inflation already at a level that would be unsatisfactory if it persisted

Although the step-up in consumer inflation to date has been rather small, some signs have emerged of greater acceleration in broad measures of costs of production Wage gains accelerated toward the end of last year Moreover, benefits took an unusually large jump in 1988, boosted in part by a sharp rise in health insurance costs and a hike in social security taxes--both of which add to business costs as directly as do wages Overall, the employment cost index, a comprehensive measure of hourly wage and benefit rates, rose 5 percent in 1988, up significantly from 1987 Materials inputs also were adding to costs; the producer price index for intermediate materials and supplies excluding food and energy rose about 7 percent over the past year

Economic Prospects and Monetary Policy for 1989

On the whole, the economic expansion remains vigorous and unusually well balanced after more than six years There are few of the tell-tale distortions, such as widespread inventory overhangs or constricted profit margins, that typically have signaled the last phases of expansions But with the economy running close to its potential, the risks seem to be on the side of a further strengthening of price pressures. In these circumstances, the Federal Reserve remains more inclined to act in the direction of restraint than toward stimulus

The determination to resist any pickup in inflation in 1989 and especially to move over time toward price stability shaped the Committee's decisions with respect to monetary and credit ranges for 1989. The Committee agreed that, particularly in this environment, progress toward these objectives likely will require continuing restraint on growth in money and credit

To this end, the Committee lowered the range for M2 by a full percentage point to 3 to 7 percent and reduced the range for M3 by 1/2 percentage point to 3-1/2 to 7-1/2 percent. The Committee also lowered the monitoring range for domestic nonfinancial sector debt by 1/2 percentage point to 6-1/2 to 10-1/2 percentage point. These were the ranges adopted on a tentative basis last June.

We decided to retain the wider, 4-percentage-point ranges that were adopted in 1988 The relationship of the monetary aggregates to economic performance has been quite variable in the 1980s The relatively high interest elasticity of the aggregates, even after deregulation, makes them very sensitive to changes in money market conditions, which in turn can respond to developments in the real economy or prices The resulting potential for sizable movements in velocity requires broader ranges in order to have reasonable assurance that the targets are consistent with satisfactory economic performance. Considerable uncertainties regarding the effects on the monetary aggregates of the resolution of the thrift institution difficulties also argue for relatively wide ranges this year. Depending on the pace of asset growth of thrifts and changes in their deposit pricing policies, the composition and growth of their liabilities could vary substantially from past patterns.

For the same reasons, the Committee agreed to continue its current approach to the implementation of policy, which involves monitoring a variety of economic and financial indicators, including growth of money and debt In this regard, appropriate growth of M2 and M3 relative to their ranges will be determined in part by developments during the year. At present, it appears that the velocities of M2 and M3 are likely to rise this year, in response to the market interest rate increases to date and unusually sluggish adjustment of deposit rates.

The Federal Reserve expects its policy in 1989 to support continued economic expansion while putting in place conditions for a gradual easing in the rate of inflation over time. However, the wage and price process may have developed some momentum The central tendency of forecasts made by members of the Federal Reserve Board and presidents of Federal Reserve Banks is for inflation to rise slightly in 1989 But let me stress that the current rate of inflation, let alone an increase, is not acceptable, and our policies are designed to reduce inflation in coming years

This restraint will involve containing pressures on our productive resources and, thus, some slowing in the underlying rate of growth of real GNP is likely in 1989 The central tendency of GNP forecasts for this year of Board members and Reserve Bank presidents is 2-1/2 to 3 percent, abstracting from the expected rebound from last year's drought losses, real GNP is projected to grow at closer to a 2 percent rate Net exports are expected to continue to improve in 1989 as we make further progress on reducing our external imbalances, but this implies the need for restraint on domestic demand to contain pressures on our productive resources. With demands for labor growing more in line with expansion of the labor force, the unemployment rate is expected to remain near its recent level over 1989

Monetary Policy and Long-run Economic Growth

Maximum sustainable economic growth over time is the Federal Reserve's ultimate objective The primary role of monetary policy in the pursuit of this goal is to foster price stability For all practical purposes, price stability means that expected changes in the average price level are small enough and gradual enough that they do not materially enter business and household financial decisions Price stability contributes to economic efficiency in part by reducing the uncertainties that tend to inhibit investment Also, it directs resources to productive economic activity that otherwise would tend to be diverted to mitigating the financial effects of inflation.

Price stability--indeed, even preventing inflation from accelerating--requires that aggregate demand be in line with potential aggregate supply. In the long run, that balance depends crucially on monetary policy. Inflation cannot persist without a *supporting expansion* in money and credit, conversely, price stability requires moderate growth in money--at rates below those prevailing in recent years.

In the short run, demands can fall short of, or run ahead of, available resources, with implications for wage and price pressures and the appropriate stance of monetary policy. By altering reserve conditions and the money supply, and thus interest and exchange rates and wealth positions, monetary policy can assist in bringing about a better match between demand and potential supply and thereby contribute to aggregate price stability

When the economy is operating below capacity, bringing demand in line with supply can involve real GNP growth that is faster for a time than its long-run potential. For example, in the mid-1980s, the U S economy was recovering from a deep recession; with utilization of labor and capital not nearly complete, we were able to bring these resources back into the production process at a pace that substantially exceeded their underlying growth rates. In those circumstances, it is not surprising that growth of real GNP was relatively rapid while inflation performance was reasonably good.

But when the economy is operating essentially at capacity, monetary policy cannot force demand to expand more rapidly than potential supply without adverse consequences. Such an attempt will result in accelerating prices and wages, as producers bid for scarcer, and at the margin less productive, labor and capital Over time it would result in little if any additional output.

As a result of robust expansion in the last few years, the U S. economy has absorbed much of its unused labor and capital resources. No one can say precisely which level of resource utilization marks the dividing line between accelerating and decelerating prices However, the evidence--in the form of direct measures of prices and wages--is clear that we are now in the vicinity of that line.

Thus, policies that foster more economic growth, if such growth is to be sustainable over the long run, should focus on aggregate supply Aggregate supply depends on the size of the labor force and its productivity Growth of the labor force basically is a function of increases in population and of individuals' decisions with regard to participation in the labor force. Labor productivity depends partly on the quantity and quality of capital and the overall efficiency in combining labor and capital in the production process Given projections of likely labor force expansion and capital accumulation, most estimates of growth in long-run potential real GNP fall in a range below the average growth rates of real nonfarm GNP experienced over the last couple of years

Faster growth in real GNP would be possible for a time if we could use more of our labor and plant capacity without putting pressure on wages and prices. Monetary policy is not a useful tool to accomplish this But microeconomic policies may well be, such as policies designed to improve the match between labor demands and supplies Conversely, we must be careful to avoid approaches to our national needs that would add unduly to business costs or increase rigidities in labor and product markets. Perhaps most important over the long run, as the composition of production in the U.S. economy continues to evolve, we must intensify our efforts to educate our labor force to be productive in the increasingly high-technology world marketplace.

In addition, the United States could improve its longer-run growth prospects by stepping up the pace of capital accumulation. Government policies can contribute to a higher rate of investment. Tax policies can help by ensuring that returns from capital are not taxed excessively or unpredictably And fiscal policy can help boost the national saving rate.

Ideally, *increased national* saving would involve some improvement in the private saving rate. Household saving is abysmally low in the United States, and business saving hasn't risen enough to offset that However, it is not clear that past government policies have been very effective in boosting private saving. Probably the most direct and sure way of increasing saving is by a reduction in government dissaving Congress should follow the Gramm-Rudman-Hollings timetable and then seek a budgetary surplus by the mid-1990s

An improving federal budget position should have a variety of favorable effects. It can pave the way for a reduction in our external imbalance by freeing resources currently absorbed by domestic demand. By putting downward pressure on real interest rates, it can encourage domestic business capital formation and make housing more affordable It can encourage households and businesses to focus more on the long run in economic planning.

Monetary policy also has a role to play in encouraging capital formation and economic growth over time, by providing a stable price environment. Although the relationship between growth of money and the economy can vary from year to year, over the long haul there is a close relationship between money and prices. Recently, the Board's staff has done some interesting research on this subject This work indicates that future changes in the rate of inflation have been fairly reliably linked to the difference between the prevailing price level and its equilibrium level That equilibrium level is calculated at the current level of M2, assuming that real GNP is at its potential and velocity is at its long-run average. As you can see from the chart, inflation apparently tends to accelerate with a lag when actual prices are below the equilibrium value associated with current M2, and to decelerate when above it. This research suggests that despite relatively moderate expansion of M2 in recent years, the equilibrium value still is a little above the current price level, reinforcing the notion that the present risks are on the side of a pickup of inflation This work also confirms that price stability ultimately will require somewhat slower M2 growth than we have experienced in recent years

Financial Developments and Monetary Policy

The Federal Reserve recognizes that monetary policy over the coming year will be carried out against the backdrop of a financial system facing certain difficulties The thrift and FSLIC situation is perhaps most pressing. The administration has proposed an extensive, workable plan for closing insolvent institutions, improving the regulation and supervision of S&Ls, and strengthening the deposit insurance funds On Thursday, I will be presenting more detailed testimony on this topic before this committee For now, let me simply encourage you and your colleagues to take the necessary legislative steps to resolve this situation promptly There appears to have been little, if any, effect of the S&L problem on mortgage availability and housing--thanks in part to financial innovation in the form of the mortgage-backed securities market. However, without quick and effective action the situation could deteriorate.

Developments in the corporate sector warrant close scrutiny as well The stock market has been recovering over the past 15 months, with few signs as yet of speculative excesses However, as you know, corporate equity continues to be retired at a startling rate in conjunction with LBOs and other mergers and restructurings and has involved issuance of a correspondingly large amount of debt. As I have noted in recent congressional testimony, this phenomenon is complex, having both positive and negative dimensions. These restructurings often have added economic value through improved efficiency--an important consideration given the increasingly competitive nature of world markets. But the higher leverage leaves these firms, and potentially their creditors, more vulnerable to financial difficulties in event of a downturn. The Federal Reserve and other federal regulators are instructing bank examiners to review especially carefully loans to highly leveraged firms in order to maintain a safe and sound banking system

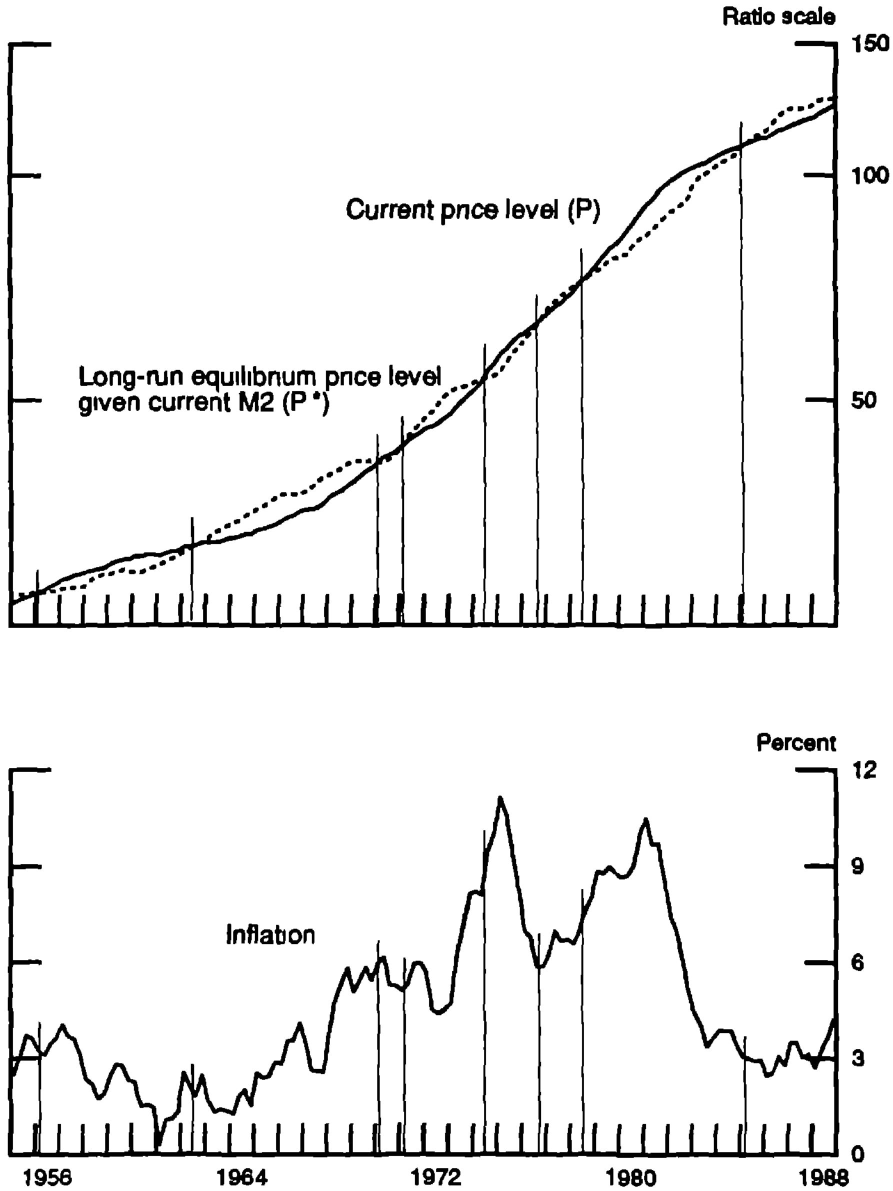
The international economy also will command the continuing attention of policymakers around the world. Among the industrial countries, greater concern about rising inflation followed the substantial economic growth recorded last year. Meanwhile, the process of adjustment of international imbalances appeared to have slowed somewhat in the second half of last year, and many developing countries continued to face serious problems of achieving sustained economic growth, fostering development, and servicing large external debts.

Some have argued that these financial stresses, taken together, could hamstring the Federal Reserve's anti-inflationary policy Certainly we have to take account of the effects of our actions on all sectors of the domestic and international economy and on financial markets; at the same time we recognize that monetary policy is not the instrument to deal with structural financial stresses and imbalances here and abroad--and that attempts to do so may even worsen these problems Backing away from policy adjustments needed to contain inflation will not solve the thrift problem, make the debt burden of heavily leveraged firms lighter, speed the process of international adjustment, or contribute to a fundamental solution of the economic problems of the developing countries. In fact, the thrift industry's problems, as well as the external debt problems of the developing countries, were exacerbated by the inflation of the 1970s Attempting to lower interest rates in the short run through more rapid money growth against countervailing market pressures would quickly raise inflationary expectations, leading soon to higher, not lower, interest rates. Instead, the structural financial problems require the prompt application of microeconomically oriented solutions within the supervisory, regulatory, and legal framework. Imbalances in the world economy require the continued, patient application of responsible macroeconomic policies in the United States and in other industrial countries, as well as further progress in economic reforms by the developing countries.

Conclusion

For its part, the Federal Reserve will continue to seek monetary conditions that will reduce inflation. Our major trading partners are following consistent policies in their own economies. Together, these policies should bring about a more stable financial environment and promote long-run worldwide economic growth. Relatively stable long-term nominal interest rates and flattening yield curves around the industrial world are strong evidence that savers and investors are in accord with this view Monetary policy, at least for the moment, appears on track in the United States. The task is to keep it on track while making necessary adjustments to fiscal policy and reforms to the regulation of financial institutions In this way we can ensure vigorous and balanced economic conditions over the long run

Inflation Indicator Based on M2



The current price level (P, the solid line in the top panel) is the implicit GNP deflator, which is set to 100 in 1982

The long-run equilibrium price level given current M2 (P*, the dashed line in the top panel), is calculated as $P^* = (M2 \times V^*)/Q^*$, where V^* is an estimate of the long-run value of the GNP velocity of M2—the mean of V2 from 1955 Q1 to 1988 Q4—and Q^* is a Federal Reserve Board staff measure of potential real GNP

The vertical lines mark the quarters when the difference between the current price level (P) and the long-run equilibrium price level (P*) switches sign, and thus when inflation, with a lag, tends to begin accelerating or decelerating

Inflation (bottom panel) is the percentage change in the implicit GNP deflator from four quarters earlier

For more details, see Jeffrey Hallman, Richard D Porter, and David H Small, *M2 Per Unit of Potential GNP as a Price-Level Anchor*, Staff Studies (Board of Governors of the Federal Reserve System, forthcoming)