For release on delivery
10:00 a.m., E.D.T.
August 1, 1989

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

August 1, 1989

Mr. Chairman and Members of the Committee: I appreciate this opportunity to appear before you in connection with the Federal Reserve's semiannual Monetary Policy Report to Congress. In my prepared remarks today I will adhere closely to the matter at hand--that is, monetary policy and the state of the nation's economy.

Economic and Monetary Developments Thus Far in 1989

Over the course of this year, the contours of the broad economic setting have changed. As a consequence, the stance of monetary policy also has shifted somewhat, although the fundamental objective of our policy has not. That objective remains to maximize sustainable economic growth, which in turn requires the achievement of price stability over time.

Early in the year, the Federal Reserve continued on the path toward increased restraint upon which it had embarked in the spring of 1988. At the time of our report to Congress in February of this year, I characterized the economy as strong, with the risks on the side of a further intensifying of price pressures. Labor markets had been tightening noticeably, heightening concerns that inflationary pressures might be building. Moreover, increases in food and crude oil prices were raising the major inflation indexes.

In view of the dimensions of the inflation threat, the Federal Reserve tightened policy further early this year. Additional reserve restraint was applied through open market operations, and the discount rate was raised 1/2 percentage point. The determination to resist any pickup in inflation also motivated the decision of the Federal Open Market Committee at its February meeting to lower the ranges for money and credit growth for 1989. This marked the third consecutive year in which the target ranges were reduced, and it underscored our commitment to achieving price stability over time.

Reflecting the economy's apparent strength and the tighter stance of policy, interest rates rose during the first quarter. Short-term market rates increased around 1 percentage point over the quarter, leaving them up more than 3 points from a year earlier, but long-term rates held relatively steady. The year-long rise in short-term rates had a marked impact on growth of the monetary aggregates, restraining the demand for money as funds flowed instead into higher-yielding market instruments.

By the beginning of the second quarter, the outlook for spending and prices was becoming more mixed. Scattered indications of an emerging softening in economic activity began to appear, prompting market interest rates to pull back. Rates continued to fall as a variety of factors pointed to some lessening of price pressures in the period ahead. In particular, money growth weakened further, the underlying trend in inflation appeared to be less severe than markets had feared, the dollar continued to climb, and domestic demand slackened. Against this background, the Federal Reserve began to ease reserve conditions in early June. The easing has consisted of several steps, the most recent of which took place last week. By the end of July, most short-term market rates had dropped more than 1-1/2 percentage points from their March peaks, and long-term interest rates were down somewhat less, with bond rates at their lowest levels in more than two years.

Economic activity is estimated to have grown in the first half of this year at a rate somewhat below that of potential GNP. This stands in sharp contrast to the performance of the preceding two years during which growth proceeded at a pace that placed increasing pressures on labor and capital resources. Job creation has remained the hallmark of the current expansion, however. Even with the more moderate pace of economic growth in the first half of this year, nearly 1-1/2 million new jobs were added to payrolls. And this occurred apparently without triggering an acceleration in wages.

Prices did accelerate in the first six months of this year, but most of the increase may be transitory, related to supply conditions in food and petroleum markets. After a gradual pickup over the preceding two years, price inflation outside of food and energy held near its 1988 pace.

Excluding food and energy is one traditional way of estimating the "underlying" rate of inflation. Although there is some logic in abstracting from these prices, which are quite volatile and can be dominated over the short run by supply disturbances, this approach is incomplete. An alternate picture of near-term price-setting behavior can be gleaned by examining the components of prices, that is, the cost pressures facing firms and the behavior of their profits. Such an analysis reveals that, in manufacturing, much of the pickup in inflation thus far in 1989 is accounted for by higher unit energy and labor costs. The runup in world crude oil prices, which reflected a series of production accidents this spring as well as a degree of output restraint on the part of some OPEC oil producers, is the main reason for the increase in energy costs.

In contrast, movements in hourly compensation were quite moderate in the first half of this year, and the acceleration in unit labor costs largely reflected slower growth in productivity. Such a deceleration in productivity is typical as the pace of economic activity slows. But, given the relatively high levels of resource utilization, it also is possible that firms were forced to draw on less skilled workers than was the case earlier in the expansion. A significant moderation in the unit cost of imported materials, likely reflecting the higher value of the dollar on foreign exchange markets, provided a notable offset to these cost pressures. On balance, it appears that firms have continued to experience upward pressures on costs. The intensity of these pressures as related to energy inputs may well diminish in coming months, but it remains to be seen how other elements of the cost structure will evolve.

This approach, while helpful in understanding the interaction of prices and costs, does not tell us how an inflation cycle begins or why it may persist. Short-run inflation impulses can originate from a variety of sources, on both the demand and the supply sides of the economy. But over longer periods of time, inflation cannot persist without at least passive support from the monetary authorities.

The strength of the inflation pressures in 1988 and into 1989 was, of course, the motive for the progressive tightening of policy that the Federal Reserve undertook over that period. And the outlook for some reduction in these pressures owes in part to that policy restraint. The associated rise in market interest rates, beginning early last year, opened up wide "opportunity" costs of holding money assets and resulted in a sharp slowing of money growth. This was especially the case for liquid deposits, whose rates were adjusted upward only very sluggishly, providing depositors with strong incentives to economize on balances.

In addition to the effect of interest rates, several special factors played a role in slowing money growth and boosting velocity--that is, the ratio of nominal GNP to money. Probably the most important of these was the unexpectedly large size of personal tax liabilities in April. Many individuals evidently were surprised by the size of their liabilities, and drew down their money balances below normal levels to make the required payments. As the IRS cashed those checks, M2 registered outright declines.

The difficulties of the thrift industry also may have affected M2 growth. Late last year, as public attention increasingly focused on the financial condition of the industry and its insurance fund, FSLIC-insured institutions began to lose deposits at a significant rate. These deposit withdrawals were particularly strong in the first quarter of this year, and while most of the funds apparently were repositioned within M2--at commercial banks or money funds--this factor likely also had some damping effect on that aggregate.

More recently, growth of the broader monetary aggregates has picked up markedly. The restraint imposed by the earlier rise in market interest rates is fading, and households appear to be rebuilding their tax-depleted balances. The level of M2 on average in May was just 1 percent at an annual rate above its fourth-quarter base, but rapid growth in June and July has lifted the year-to-date increase to around the lower end of its 3 to 7 percent annual target cone. M3 also has accelerated in June and July, placing it well into the lower half of its range.

M1, which is the most interest-sensitive of the monetary aggregates, declined at a 3-1/2 percent rate through June, although it too has strengthened most recently. The unusual drop in M1 in the first half of the year stemmed from sizable declines in NOW accounts and demand deposits. NOW accounts were reduced both by the large personal tax payments this spring and by the high level of interest rates, which drew savings-type balances instead toward market instruments or other types of accounts whose offering rates adjusted upward more quickly. The decline in demand deposits was related in part to a reduction in balances that businesses are required to hold to compensate their banks for various services; for a set amount of services, higher market rates translate into lower required balances.

Monetary Policy and the Economy into 1990

Looking ahead at the remainder of 1989 and into 1990, recent developments suggest that the balance of risks may have shifted somewhat away from greater inflation. Even so, inflation remains high--clearly above our objective. Any inflation that persists will hinder the economy's ability to perform at peak efficiency and to create jobs. Consequently, monetary policy will need to continue to focus on laying the groundwork for gradual progress toward price stability. Such an outcome need not imply a marked downturn in the economy, and policy will have to be alert to any emerging indications of a cumulative weakening of activity. However, progress on inflation and optimum growth over time also require that our productive resources not be under such pressures that their prices continue to rise without abating. In light of historical patterns of labor and capital growth and productivity, this progress very likely will be associated with a more moderate, and hence sustainable, expansion in demand than we experienced in 1987 and 1988.

At its meeting last month, the Federal Open Market Committee determined that a combination of continued economic growth and reduced pressures on prices would be promoted by growth of money and debt in 1989 within the annual ranges that were set in February. Moreover, it tentatively decided to maintain these same ranges through 1990.

The specified ranges, both for this year and next, retain the 4-percentage-point width first instituted for the broader aggregates in 1988. Considerable uncertainties about the behavior of money and credit remain, and the greater breadth allows for a range of paths for these aggregates as financial and economic developments may warrant. Uncertainties about the link between the narrow transactions aggregate, M1, and the economy have, if anything, increased, and the Committee once again did not specify a range for this aggregate.

In view of the apparent variability, particularly over the short run, in the relationships between the monetary aggregates and the economy, policy will continue to be carried out with attention to a wide range of economic and financial indicators. The complex nature of the economy and the chance of false signals demand that we cast our net broadly--gathering information on prices, real activity, financial and foreign exchange markets, and related data.

While the monetary aggregates may not be preeminent on this list, they always receive careful consideration in our policy decisions. This is especially true when they exhibit unusual strength or weakness relative to past patterns and relative to our announced ranges. Thus, the very sluggish growth in M2 for the year to date was an important influence in the decision to begin to ease policy. Velocity may vary considerably over a few quarters, but the provision of liquidity, as measured by one or another of the monetary aggregates, is an important factor in the performance of the economy over the shorter run and over the long run broadly determines the rate of price increase.

Over the remainder of the year, M2 should continue to be supported by the decline in interest rates in recent months, which, along with growth of income, is likely to result in an expansion of that aggregate well within its target range. Growth in M2 likely will be augmented by a cessation of the special influences I noted earlier that depressed it in the first half of the year. In particular, households may continue to rebuild their money balances after the tax-related drawdowns in April and May. Also, deposit withdrawals from thrift institutions have subsided, and enactment of legislation that restores full confidence in the industry would bode well for deposit flows into FSLIC-insured institutions.

Further steps in the resolution of the thrift industry difficulties also have implications for M3. With deposits flowing in again, thrifts will not have to rely so heavily on the Federal Home Loan Banks for their funding as they did earlier this year. Partly as a result, we expect

M3 to strengthen from its rate of growth over the first half of the year, moving up into the middle of its target range by year-end.

Our outlook for debt growth foresees little change from the pace of the first two quarters. The broad credit measure that we monitor, the debt of domestic nonfinancial sectors, has grown at about an 8 percent rate this year, near the midpoint of its 6-1/2 to 10-1/2 percent range. We have little reason to expect its growth through the end of the year to be very different, implying some slowing from the pace of 1988. Nevertheless, the expansion of debt is likely to exceed nominal GNP growth again this year.

Growth of money and debt within the 1989 ranges is expected to be consistent with nominal GNP rising this year at a pace not too far from last year's increase, according to the projections of FOMC members and other presidents of Reserve Banks. These projections, however, incorporate somewhat more inflation and less real growth than we experienced in 1988. The central tendency of the projections of 2 to 2-1/2 percent real GNP growth over the four quarters of this year implies continued moderate economic growth throughout the year. For the year as a whole, these projections anticipate that growth is likely to be strongest in the investment and export sectors of the economy, with expansion of consumer expenditures and government purchases rather subdued.

A sectoral pattern of growth such as this would in fact serve the nation's longer-term needs by contributing to a better external balance. Fundamentally, improvement in our international payments position requires productivity-enhancing investment and a higher national saving rate. In this regard the federal government can play a significant, positive role by reducing the budget deficit.

The outlook for inflation this year, as reflected in the central tendency of the projections expressed at the FOMC meeting, is for a 5 to 5-1/2 percent increase in the consumer price index. A figure in this range would represent the highest annual inflation rate in the United States since 1981; this is a source of concern to the Federal Reserve. Yet this rate is below that experienced in the first six months. This implies a considerable slowing over the remainder of the year, reflecting earlier monetary policy restraint and a prospective moderation in food and energy prices.

Federal Reserve policy is focused on laying the groundwork for more definite progress in reducing inflation pressures in 1990, while continuing support for the economic expansion. The ranges provisionally established for growth of money and debt next year are consistent with these intentions. They allow for a noticeable pickup in money growth from that likely to prevail this year, should that be appropriate. If pressures on prices and in financial markets are less intense than in recent years, velocity would not be expected to continue to increase, and faster money growth, perhaps in the top half of the range, would be needed for a time to support economic growth. Conversely, if price pressures prove intractable, the ranges are low enough to permit the needed degree of monetary restraint.

Thus, although the 1990 ranges do not represent another step in the gradual, multiyear lowering of ranges, the Federal Reserve's intent to make further progress against inflation remains intact. Uncertainties about the outlook suggested a pause in the process of reducing the ranges; however, the Committee recognizes that our goal of price stability will require additional downward adjustments in these ranges over time. Of course, as we draw closer to 1990, the economic and financial conditions prevailing will become clearer, allowing us to approach our decisions on the ranges with more confidence. Hence, the current ranges for money and credit growth in 1990 should be viewed as very preliminary.

The economic projections for 1990 made by the governors and Reserve Bank presidents center in a range of 1-1/2 to 2 percent real GNP growth and 4-1/2 to 5 percent inflation for next year. Naturally, as I've already noted, there are considerable uncertainties surrounding forecasts for 1990. In particular, developments in the external sector will depend in part on economic activity abroad, as well as on the efforts of U.S. firms to become more competitive in world markets. Domestically, performance will be affected by a large number of influences, including importantly the budget deficit.

Monetary Policy in Perspective

The Federal Reserve is committed to doing its utmost to ensure prosperity and rising standards of living over the long run. Given the powers and responsibilities of the central bank, that means most importantly maintaining confidence in our currency by maintaining its purchasing power. The principal role of monetary policy is to provide a stable backdrop against which economic decisions can be made. A stable, predictable price environment is essential to ensure that resources can be put to their best use and ample investment for the future can be made.

In the long run, the link between money and prices is unassailable. That link is central to the mission of the Federal Reserve, for it reminds us that without the acquiesence of the central bank, inflation cannot take root. Ultimately, the monetary authorities must face the responsibility for lasting price trends. While oil price shocks, droughts, higher taxes, or new government regulations may boost broad price indexes at one time or another, sustained inflation requires at least the forbearance of the central bank. Moreover, as many nations have learned, inflation can be corrosive. As it accelerates, the signals of the market system lose their value, financial assets lose their worth, and economic progress becomes impossible.

Thankfully, this bleak scenario is not one that we in the United States are confronting. We do, however, face a difficult balancing act. The economy has prospered in recent years: the economic expansion has proven exceptionally durable, employment has surpassed all but the most optimistic expectations, and the underlying inflation rate, after coming down quickly in the early 1980s, has accelerated only modestly. But now signs of softness in the economy have shown up.

Accordingly, it is prudent for the Federal Reserve to recognize the risk that such softness conceivably could cumulate and deepen, resulting in a substantial downturn in activity. We also recognize, however, that a degree of slack in labor and product markets will ease the inflationary pressures that have built up. So our policy, under current circumstances, is not oriented toward avoiding a slowdown in demand, for a slowing from the unsustainable rates of 1987 and 1988 is probably unavoidable. Rather what we seek to avoid is an unnecessary and destructive recession.

The balance that we must strike is to support moderate growth of demand in the near term, while concurrently progressing toward our longer-run goal of a stable price level. Admittedly, the balance we are seeking is a delicate one. I wish I could say that the business cycle has been repealed. But some day, some event will end the extraordinary string of economic advances that has prevailed since late 1982. For example, an inadvertent, excess accumulation of inventories or an external supply shock could lead to a significant retrenchment in economic activity.

Moreover, I cannot rule out a policy mistake as the trigger for a downturn. We at the Federal Reserve might fail to restrain a speculative surge in the economy or fail to recognize that we were holding reserves too tight for too long. Given the lags in the effects of policy, forecasts inevitably are involved and thus errors inevitably arise. Our job is to keep such errors to an absolute minimum. An efficient policy is one that doesn't lose its bearings, that homes in on price stability over time, but that copes with and makes allowances for any unforeseen weakness in economic activity. It is such a policy that the Federal Reserve will endeavor to pursue.