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Testimony by

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Chairman

Board of Governors of the Federal Reserve System

before the

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of the

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Mr. Chairman and Members of the Committee, I appreciate the opportunity to testify today on the Federal Reserve's semiannual Monetary Policy Report to the Congress My prepared remarks discuss our monetary policy actions and plans in the context not only of the current and projected state of the economy, but also against the background of our longer-term objectives and strategy for achieving them The testimony also addresses some issues for monetary policy raised by the increasingly international character of financial markets

**Economic and Monetary Policy Developments in 1989**

Last year marked the seventh year of the longest peacetime expansion of the U S economy on record Some 2-1/2 million jobs were created, and the civilian unemployment rate held steady at 5-1/4 percent Inflation was held to a rate no faster than that in recent years, but unfortunately no progress was made in 1989 toward price stability Thus, while we can look back with satisfaction at the economic progress made last year, there is still important work to be done

About a year ago, Federal Reserve policy was in the final phase of a period of gradual tightening, designed to inhibit a buildup of inflation pressures Interest rates moved higher through the winter, but started down when signs of more restrained aggregate demand and of reduced potential for higher inflation began to appear As midyear approached, a marked strengthening of the dollar on foreign exchange markets further diminished the threat of accelerating inflation New economic data suggested that the balance of risks had shifted toward the possibility of an undue weakening in economic activity. With M2 and M3

below the lower bounds of their annual ranges in the spring, the Federal Reserve in June embarked on a series of measured easing steps that continued through late last year Across the maturity spectrum, interest rates declined further, to levels about 1-1/2 percentage points below March peaks Reductions in inflation expectations and reports of a softer economy evidently contributed to the drop in rates in longer-term markets

The decrease in short-term rates lifted M2 to around the middle of its annual range in the latter part of the year Efforts under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to close insolvent thrift institutions and strengthen undercapitalized thrifts led to a cutback of the industry's assets and funding needs This behavior held down M3 growth in the second half of the year, and that aggregate ended the year around the lower end of its annual range. The restructuring of the thrift industry did not, however, seem to appreciably affect the overall cost and availability of residential mortgage credit, as other suppliers of this credit stepped into the breach In the aggregate, the debt of nonfinancial sectors slowed somewhat, along with spending, to a rate just below the midpoint of its annual range

So far this year, the federal funds rate has remained around 8-1/4 percent, but rates on Treasury securities and longer-term private instruments have reversed some of their earlier declines Investors have reacted to stronger-than-expected economic data, a runup in energy

prices, and increasingly attractive investment opportunities abroad, especially in Europe

**The Ultimate Objectives and Medium-Term Strategy of Monetary Policy**

Monetary policy was conducted again last year with an eye on long-run policy goals, and economic developments in 1989 were consistent with the Federal Reserve's medium-term strategy for reaching them The ultimate objective of economic policy is to foster the maximum sustainable rate of economic growth This outcome depends on market mechanisms that provide incentives for economic progress by encouraging creativity, innovation, saving, and investment Markets perform these tasks most effectively when individuals can reasonably believe that by forgoing consumption or leisure in the present they can reap adequate rewards in the future Inflation insidiously undermines such confidence It raises doubts in people's minds about the future real value of their nominal savings and earnings, and it distorts decision-making Faced with inflation, investors are more likely to divert their attention to protecting the near-term purchasing power of their wealth Modern-day examples of economies stunted by rapid inflation are instructive. In countries with high rates of inflation, people tend to put their savings in foreign currencies and commodities rather than in the financial investments and claims on productive assets that can best foster domestic growth. By ensuring stable prices, monetary policy can play its most important role in promoting economic progress

The strategy of the Federal Open Market Committee (FOMC) for moving toward this goal remains the same--to restrain growth in money and

aggregate demand in coming years enough to establish a clear downward tilt to the trend of inflation and inflation expectations, while avoiding a recession Approaching price stability may involve a period of expansion in activity at a rate below the growth in the economy's potential, thereby relieving pressures on resources Once some slack develops, real output growth can pick up to around its potential growth rate, even as inflation continues to trend down Later, as price stability is approached, real output growth can move still higher, until full resource utilization is restored

While these are the general principles, no one can be certain what path for the economy would, in practice, accompany the gradual approach to price stability One key element that would minimize the costs associated with the transition would be a conviction of participants in the economy that the anti-inflation policy is credible, that is, likely to be effective and unlikely to be reversed

Stability of the general price level will yield important long-run benefits Nominal interest rates will be reduced with the disappearance of expectations of inflation, and real interest rates likely will be lower as well, as less uncertainty about the future behavior of overall prices induces a greater willingness to save Higher saving and capital accumulation will enhance productivity, and the trend growth in real GNP will be greater than would be possible if the recent inflation rate continued

If past patterns of monetary behavior persist, maintaining price stability will require an average rate of M2 growth over time approximately equal to the trend growth in output During the transition, the decline of market interest rates in response to the moderation in inflation would boost the public's demand for M2 relative to nominal spending, lowering M2 velocity M2 growth over several years accordingly may show little deceleration, and it could actually speed up from time to time, as interest rates decline in fits and starts. Hence, the FOMC would not expect to lower its M2 range mechanically each and every year in the transition to price stability

This qualitative description of our medium-term strategy is easy to state, but actually implementing it will be difficult Unexpected developments no doubt will require flexible policy responses Any such adjustments will not imply a retreat from the medium-term strategy or from ultimate policy goals. Rather, they will be mid-course corrections that attempt to keep the economy and prices on track The easing of reserve pressures starting last June is a case in point Successive FOMC decisions to ease operating policy were intended to forestall an economic downturn, the chances of which seemed to be increasing as the balance of risks shifted away from greater inflation. The FOMC was in no way abandoning its long-run goal of price stability. Instead, it sought financial conditions that would support the moderate economic expansion judged to be consistent with progress toward stable prices In the event, output growth was sustained last year, although in the fourth quarter a major strike at Boeing combined with the first round of production cuts

in the auto industry accentuated the underlying slowdown On the inflation side, price increases in the second half were appreciably lower than those in the first Although the CPI for January, as expected, showed a sizable jump in energy and food prices in the wake of December's cold snap, a reversal is apparently underway

**Monetary Policy and the Economic Outlook for 1990**

Against this background, the Federal Reserve Governors and the Presidents of Reserve Banks foresee continued moderate economic expansion over 1990, consistent with conditions that will foster progress toward price stability over time At its meeting earlier this month, the FOMC selected ranges for growth in money and debt it believes will promote this outcome

My testimony last July indicated the very preliminary nature of the tentative ranges chosen for 1990, given the uncertain outlook for the economy, financial conditions, and appropriate growth of money and debt With the economic situation not materially different from what was anticipated at that time, the FOMC reaffirmed the tentative 3 to 7 percent growth range for M2 in 1990 that it set last July This range, which is the same as that used in 1989, is expected by most FOMC members to produce somewhat slower growth in nominal GNP this year The declines in short-term interest rates through late last year can be expected to continue to boost the public's demands for liquid balances in M2, at least for a while longer M2 growth over 1990 thus may be faster than in recent years, and M2 velocity could well decline over the four quarters

of the year, absent a pronounced firming in short-term market interest rates

In contrast with M2, the range for M3 has been reduced from its tentative range set last July The new M3 range of 2-1/2 to 6-1/2 percent is intended to embody the same degree of restraint as the M2 range, but it was lowered to reflect the continued decline in thrift assets and funding needs now anticipated to accompany the ongoing restructuring of the thrift industry This asset runoff began in earnest in the second half of last year, so its magnitude was not incorporated into the tentative M3 range for 1990 set last July The bulk of the mortgage and real estate assets that thrifts will shed are expected to be acquired by the Resolution Trust Corporation and diversified investors other than depository institutions Such assets thus will no longer be financed by monetary instruments included in M3 In addition, commercial banks are likely to be more cautious in their lending activities, reducing their need to issue wholesale managed liabilities included in M3 These influences should retard the growth of M3 relative to M2 again this year

The debt of domestic nonfinancial sectors is expected to decelerate along with nominal GNP for a fourth straight year, and the Committee chose to lower the monitoring range for this aggregate to 5 to 9 percent for 1990. Merger and acquisition activity has retreated from the feverish pace of recent years, reflecting some well-publicized difficulties of restructured firms and more caution on the part of creditors All other things equal, less restructuring activity and greater use of equity

finance imply reduced corporate borrowing An ebbing of growth in household debt also seems probable.

Over the last decade, money and debt aggregates have become less reliable guides for the Federal Reserve in conducting policy The velocities of the aggregates have ranged widely from one quarter or one year to the next, in response to interest rate movements and special factors In the coming year, the effects of the contraction of the thrift industry on the velocity of M3, and to a lesser extent on that of M2, are especially difficult to predict While recognizing that the growth rates of the broader monetary aggregates over long periods are still good indicators of trends in inflation, the FOMC will continue to take an array of factors into account in guiding operating policy Information about emerging patterns of inflationary pressure, business activity, and conditions in domestic and international financial markets again will need to supplement monetary data in providing the background for decisions about the appropriate operating stance

The Committee's best judgment is that money and debt growth within these annual ranges will be compatible with a moderation in the expansion of nominal GNP Most FOMC members and other Reserve Bank presidents foresee real GNP growing 1-3/4 to 2 percent over the year as a whole Such a rate would be around last year's moderate pace, excluding the rebound in agricultural output from the 1988 drought. A slight easing of pressures on resources probably is in store Inflation pressures should remain contained, even though the decline in the dollar's value over the past half-year likely will reverse some of the beneficial

effects on domestic inflation stemming from the dollar's earlier appreciation The CPI this year is projected to increase 4 to 4-1/2 percent, as compared with last year's 4-1/2 percent

**Risks to the Economic Outlook**

Experience has shown such macroeconomic forecasts to be subject to a variety of risks Assessing the balance of risks between production shortfalls and inflation pressures in the current outlook is complicated by several cross-currents in the domestic and international economic and financial situation

One risk is that the weakness in economic activity evident around year-end may tend to cumulate, causing members' forecasts about production and employment this year to be overly optimistic However, available indicators of near-term economic performance suggest that the weakest point may have passed The inventory correction in the auto industry--a rapid one involving a sharp reduction in motor vehicle assemblies in January coupled with better motor vehicle sales--seems to be largely behind us Industrial activity outside of motor vehicles appears to be holding up. Production of business equipment, where evidence has accumulated of some stability--if not an increase--in orders for capital goods, is likely to support manufacturing output in coming months. Housing starts were depressed in December by severely cold weather in much of the country But starts bounced back strongly in January, in line with the large gain in construction employment last month. From these and similar data, one can infer the beginnings of a modest firming in economic activity While we cannot be certain that we

are as yet out of the recessionary woods, such evidence warrants at least guarded optimism

There are, however, other undercurrents that continue to signal caution One that could disturb the sustainability of the current economic expansion has been the recent substantial deterioration in profit margins. A continuation of this trend could seriously undercut the still expanding capital goods market However, if current signs of an upturn in economic activity broaden, profit margins can be expected to stabilize

A more deep-seated concern with respect to the longer-run viability of the expansion is the increase in debt leverage Although the trends of income and cash flow may have turned the corner, the structure of the economy's financial balance sheet weighs increasingly heavily on the dynamics of economic expansion. In recent years, business debt burdens have been enlarged through corporate restructurings, and as a consequence interest costs as a percent of cash flow has risen markedly Responding to certain well-publicized debt-servicing problems, creditors have become more selective in committing funds for these purposes Within the banking industry, credit standards have been tightened for merger and LBO loans, as well as for some other business customers Credit for construction projects reportedly has become less available because of FIRREA-imposed limits and heightened concerns about overbuilding in a number of real estate markets

Among households, too, debt-servicing burdens have risen to historic highs relative to income, and delinquency rates have moved up of

late Suppliers of consumer and mortgage credit appear to have tightened lending terms a little Real estate values have softened in some locales, although prices have maintained an uptrend in terms of the national averages, especially for single-family residences These and other financial forces merit careful monitoring While welcome from a supervisory perspective, more cautious lending does have the potential for damping aggregate demand

It is difficult to assess how serious a threat increased leverage is to the current levels of economic activity Clearly, should the economy fall into a recession, excess debt service costs would intensify the problems of adjustment But it is unlikely that in current circumstances strains coming from the economy's financial balance sheet can themselves precipitate a downturn As I indicated earlier, we expect nonfinancial debt growth to continue to slow from its frenetic pace of the mid-1980s This should lessen the strain and hopefully the threat to the economy

**International Financial Markets and Monetary Policy**

Among other concerns, recent events have highlighted the complex interactions between developments in the U.S economy and financial markets and those in the other major industrial countries Specifically, the parallel movements in long-term interest rates here and abroad over the early weeks of 1990 have raised questions: To what extent is the U S. economy subject to influences from abroad? To what extent, as a consequence, have we lost control over our economic destiny? The simple answer to these questions is that the U S economy is influenced from

abroad to a substantially greater degree than, say, two or three decades ago, but U.S. monetary policy is, nonetheless, able to carry out its responsibilities effectively

The post-war period has seen markedly closer ties among the world's economies Markets for goods have become increasingly, and irreversibly, integrated as a result of the downsizing of economic output and the consequent expansion of international trade The past decade, in particular, also has witnessed the growing integration of financial markets around the world Advancing technology has fostered the unbundling and transfer of risk and engendered a proliferation of new financial products Cross border financial flows have accordingly accelerated at a pace in excess of global trade gains This globalization of financial markets has meant that events in one market or in one country can affect within minutes developments in markets throughout the world

More integrated and open financial markets have enabled all countries to reap the benefits of enhanced competition and improved allocation of capital. Our businesses can raise funds almost anywhere in the world Our savers can choose from a lengthening menu of investments as they seek the highest possible return on their funds Our financial institutions enjoy wider opportunities to compete

In such an environment, a change in the expected rate of return on financial assets abroad naturally can affect the actions of borrowers or lenders in the United States In response, exchange rates, asset prices, and rates of return all may adjust to new values

Strengthened linkages among world financial markets affect all markets and all investors Just as U.S markets are influenced by developments in markets abroad, foreign markets are influenced by events here These channels of influence do not depend on whether a country is experiencing a deficit or a surplus in its current account In today's financial markets, the net flows associated with current account surpluses and deficits are only the tip of the iceberg What are more important are the huge stocks of financial claims--more than $1 5 trillion held in the United States by foreigners and more than $26 trillion of dollar-denominated claims on U S borrowers held by U S. residents This is in addition to the vast quantities of assets held in foreign currencies abroad It is these holdings that can respond to changes in actual and expected rates of return

In recent years we have seen several instances in which rates of return have changed essentially simultaneously around the world For example, stock prices moved together in October 1987 and 1989, and in 1990 bond yields have risen markedly in many industrial countries

However, we must be cautious in interpreting such events, and in drawing implications for the United States Frequently, such movements occur in response to a common worldwide influence Currently, the world economy is adjusting to the implications of changes in Eastern Europe, where there are tremendous new opportunities to invest and promote reconstruction and growth Those opportunities, while contributing to the increase in interest rates in the United States, also open up new markets for our exports.

Moreover, despite globalization, financial markets do not necessarily move together--they also respond to more localized influences Over 1989, for example, bond yields in West Germany and Japan rose about a percentage point, while those in the United States fell by a similar amount The contrast between 1989 and 1990 illustrates the complexity of relationships among financial markets Interactions can show through in movements in exchange rates as well as interest rates, and changes in the relative prices of assets depend on a variety of factors, including economic developments and inflation expectations in various countries as well as monetary and fiscal policies here and abroad

The importance of foreign economic policies for domestic economic conditions has given rise in recent years to a formalized process of policy coordination among the major industrial countries The purpose of such coordination is to help policymakers achieve better performance in their national economies It begins with improved communication among authorities about economic developments within each country It includes systematic analysis of the likely impact of these developments on the economies of the partner countries and on variables such as exchange rates that are inherently jointly determined in international markets Within such a framework, it is possible to consider alternative choices for economic policies and to account explicitly for the impacts of likely policy measures in one country on the other economies

The influence of economic policies abroad and other foreign developments on the U S economy is profound, and the Federal Reserve must carefully take them into account when considering its monetary

policy. But these influences do not fundamentally constrain our ability to meet our most important monetary policy objectives Developments within U S financial markets remain the strongest influence on the asset prices and interest rates determined by those markets and, through them, on the U S. economy Exchange rates absorb much of the impact of developments in foreign asset markets, permitting U S interest rates to reflect primarily domestic economic conditions Exchange rates influence the prices of products that do, or can, enter into international trade Such factors can bring about changes in the composition of production between purely domestic goods and services and those entering international trade, and they can affect aggregate price movements for a time

However, the overall pace of spending and output in the United States depends on the demands upon all sectors of the U S economy taken together And our inflation rate, over time, depends on the strength of those demands relative to our ability to supply them out of domestic production Because the Federal Reserve is able to affect short-term interest rates in U S financial markets, it is able to influence the pace of economic activity in the short-run and inflationary pressures longer-term To be sure, monetary policy must currently balance more factors than in previous decades But our goals are still achievable

Monetary policy is only one tool, however, and it cannot be used successfully to meet multiple objectives The Federal Reserve, for example, can address itself to either domestic prices or exchange rates but cannot be expected to achieve objectives for both simultaneously Monetary policy alone is not readily capable of addressing today's large

current account deficit, which is symptomatic of underlying imbalances among saving, spending, and production within the U.S economy. Continued progress in reducing the federal deficit is a more appropriate instrument to raise domestic saving and free additional resources for productive investment. The long-term health of our economy requires the balanced use of monetary and fiscal policy in order to reach all of the nation's policy objectives

**Considerations Regarding Immediate Release of FOMC Operating Decisions**

Finally, Mr Chairman, you requested that I address an issue that has been prominent in recent discussions of the procedures used to implement policy on a day-to-day basis I refer to the way the Federal Reserve communicates its policy decisions to the public The selection of money and debt ranges is aired promptly and thoroughly in the semiannual reports and testimonies Changes in the discount rate are immediately announced in a press release

Decisions made about open market operations at and between FOMC meetings are conveyed to the markets and to the public at large through those operations. In practice, there is little lag between a discrete change in operating policy and the wide recognition of that change, despite the absence of an immediate public announcement Guidance for those operations is given to the Account Manager at the Federal Reserve Bank of New York as a Directive, which is made public shortly after the next FOMC meeting, six to seven weeks later

Suggestions have been made that we release the Directive immediately after an FOMC meeting, or announce publicly any change in our

operating objectives as it occurs These suggestions have appeal. surely more information is better than less in promoting efficient financial markets, and the need to infer the Federal Reserve's policy stance from its actions can give rise to mistakes and unnecessary market volatility

Yet the amount of genuine new information that would be released is small; it is subject to misinterpretations, and its premature announcement could adversely affect the policy process

For example, the Directive itself cannot capture all the considerations that guide Committee policy for the intermeeting period It needs to be accompanied by the record of the Committee's deliberations, which takes several weeks to prepare properly Moreover, early release could provoke overreactions in financial markets to contingencies or reserve pressure alternatives mentioned in a Directive that may not occur, or that may be superseded by intermeeting developments and adjustments To the extent that market participants anticipate contingencies in the Directive that never materialize, the markets would be subjected to unnecessary volatility.

Earlier release of the Directive would, in addition, force the Committee itself to focus on the market impact of the announcement as well as on the ultimate economic impact of its actions. To avoid premature market reaction to mere contingencies, FOMC decisions could well lose their conditional character Given the uncertainties in economic forecasts and in the links between monetary policy actions and

economic outcomes, such an impairment of flexibility in the evolution of policy would be undesirable.

Wide movements in bond and stock prices occur when investors receive new information that significantly alters their expectations over a relatively long-term horizon. Normally, changing perceptions about the current operating stance of monetary policy play only a minor role in episodes of financial variability. For example, over the last two months, U S bond and stock prices fell appreciably on balance, with fairly wide day-to-day and even intraday swings, but there was no uncertainty or change of view about the current stance of operating policy To the extent that any of these market movements reflected policy, they must have been reactions to prospective changes in policy But announcements of future changes in operating policy are not possible, since they are contingent upon future economic developments

Changes in our current operating stance, of course, have the potential to alter anticipations of future conditions, including future policy At times, monetary policymakers wish to strengthen the market's sense of a more basic change in the thrust of policy through an announcement effect, as well as through a change in the instrument itself. Changes in the discount rate provide good examples

More often, however, the Federal Reserve judges that policy implementation is better served through small, incremental operating moves that do not connote a significant alteration in policy intent and do not have major implications for financial conditions in the more

distant future. Signaling such policy moves through open market operations usually avoids major and potentially destabilizing movements in bond and stock prices

This way of distinguishing the nature of policy intent may well convey information to the financial markets about the future direction of policy better than would a formal, immediate announcement of every policy change