

Statement by

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before the

Subcommittee on Domestic Monetary Policy  
House Committee on Banking, Finance and Urban Affairs

U S House of Representatives

July 24, 1990

Mr. Chairman and Members of the Committee, I am pleased to be here today to testify in connection with our semiannual Monetary Policy Report to the Congress. In my prepared remarks this morning I shall discuss, as is customary on such occasions, current and prospective economic conditions and the Federal Reserve's objectives for money and credit growth over the period ahead. Two areas of particular note at present, with potential implications for the conduct of monetary policy, are the ongoing restructuring of credit flows in the U.S. economy and the prospects for a significant cut in the federal budget deficit. I shall pay special attention to these topics in my statement.

#### Economic and Financial Developments Thus Far in 1990

When I came before this Committee in February, I characterized the economy as poised for continued moderate expansion in 1990, and, in large measure, developments so far this year appear to have borne that statement out. Real GNP grew at a 2 percent annual rate in the first quarter, and indicators of economic activity for the second quarter suggest a further rise, though perhaps at a somewhat slower rate. Within this whole, however, the various sectors have moved along at different paces.

On the distinctly positive side, exports have shown solid gains, buoyed by expanding markets abroad. The impetus from international trade has been important in the pickup in industrial production this year.

In contrast, the news coming from the household sector in recent months has had a softer cast to it. Consumers appear to have

pulled back a bit, as the slower overall pace of expansion and the more pronounced weakness in certain parts of the country--especially the Northeast--seem to have taken some toll on confidence in the economic outlook. Moreover, having accumulated large stocks of automobiles and other consumer durables earlier in the expansion, consumers could be more selective about when to purchase replacements. Sales of new homes also have weakened, deterring building activity.

There are other pluses and minuses, as well, in the economic picture--by sector and by region. But, on balance, the economy still appears to be growing, and the likelihood of a near-term recession seems low, in part because businesses have been working hard to keep their inventories in line with sales trends.

Although output overall grew rather modestly over the first half, the unemployment rate remained at its lowest level in almost 20 years. Over the past year, as employment has decelerated, so too has the labor force, in part reflecting a surprising decline in labor force participation rates for young people. Some flattening in the aggregate participation rate would be consistent with evidence that many individuals now perceive job opportunities as less abundant. Differences from past cyclical experiences, however, suggest that other factors also must be at work--if, in fact, the current pattern represents something more than noise in the data. This development certainly bears watching, for it may have implications for potential output growth.

Be that as it may, with hiring proceeding at a less rapid pace, the rate of increase in wages appears to have leveled out from its

earlier upward trend. The core rate of inflation in consumer prices, proxied by abstracting from movements in food and energy prices, picked up sharply in the first quarter, but has moderated in recent months. This moderation has been concentrated in the prices of goods, perhaps reflecting the ebbing of capacity pressures in a number of industries, while service price inflation has shown little sign of abating.

In 1990, Federal Reserve policy has continued to be directed at sustaining the economic expansion while making progress toward price stability. Ultimately, the two go hand in hand. A stable price level sets the stage for the economy to operate at its peak efficiency, while high inflation inevitably sows the seeds of recession and wrenching readjustment. In the short run, however, the risks of inflation, on the one hand, and of an economic downturn, on the other, must be weighed in the policymaking process. The Federal Reserve saw those risks as about evenly balanced over the first half of the year and made no adjustments in monetary policy.

Throughout this period, which has been marked by dramatic changes in the flow of funds through depository institutions, the Federal Reserve has been paying particularly close attention to conditions in credit markets. Evidence of a tightening of terms and reduced availability of credit has gradually accumulated, to the point where it became apparent in recent days that some action by the monetary authority was warranted. A number of indicators have been pointing in this direction, including the behavior of the monetary aggregates. Growth in M2, for example, which stalled out in the spring, has failed to strengthen materially, suggesting that the degree of financial

restraint in train might be greater than anticipated or than appropriate to the evolving economic situation. This restraint is a function of developments in the credit markets, independent of monetary policy. The recent decline in the federal funds rate to 8 percent, as a consequence of our action to reduce slightly the pressures in reserve markets, represents an effort to offset the effects of greater stringency in credit markets.

Other market interest rates generally rose early in 1990, as it became apparent that the economy was not as weak as many had thought. Long-term yields were most affected, increasing a full percentage point by early May. Subsequently, however, signs of a softening of activity prompted a reversal of much of that runup. Rates on long-term securities remain about 1/2 percentage point above their year-end levels, but money market quotes are now little changed on balance. Throughout this period, rates on Treasury bills have remained somewhat higher than usual relative to those on private instruments, probably in part reflecting the large amount of bill issuance necessary to fund working capital for the RTC.

The runup in market interest rates early in the year was one factor behind the sharp slowing in money growth over the first half of 1990. M2, which had been running close to the top of its target range in February, posted no net increase between March and June. This weakness, which moved the aggregate close to the bottom of its range, was too abrupt to be accounted for fully by the rise in market rates, however. Another of the factors at work was the restructuring of financial flows. One aspect of this restructuring was the closing of

insolvent thrifts by the RTC and sale of their deposit bases. Although the RTC's activities do not directly affect M2, the availability of huge blocks of deposits to the remaining thrifts and banks lessened their need to raise rates to draw in funds. In combination with the more cautious attitude depositories have exhibited toward expanding their balance sheets, the deposit transfers contributed to an unusual degree of inertia in the pricing of retail deposits. Households responded to the relatively low returns on deposits by looking elsewhere, as suggested by heavy flows into stock and bond mutual funds and sizable noncompetitive tenders at Treasury auctions. Nevertheless, while the movements in yield spreads can account for a good share of the slump in M2 growth, a portion of it still requires explanation.

The cause for the meager growth this year in the broader monetary aggregate, M3, is clearer. The RTC closed down a very large number of S&Ls, taking many of those institutions' assets onto the government's balance sheet and thereby effectively reducing the overall funding needs of the depository system. In addition, increased loan losses and the phasing-in of tighter capital requirements circumscribed the expansion of credit at many other thrifts and banks. With depository credit growth limited, M3--which contains much of the associated funding--essentially stalled. By June, M3 growth was well below the 2-1/2 percent lower bound of the target range the FOMC had set in February.

That range had itself been reduced a full percentage point from the target provisionally set last July in recognition of the potential effects of the ongoing contraction of the thrift industry. Lacking

historical experience with a financial restructuring like the current one, however, it was unclear exactly how the flows would end up being redirected through the financial system and, in particular, how much of the thrift lending would be picked up by commercial banks. While the economy more broadly is about where we expected it to be, the configuration of the financial system is somewhat different, leading to less M3 growth than had been anticipated.

#### Credit Conditions

The weakness in the monetary aggregates in part signals a change in the behavior of depository institutions, with potential for affecting overall credit provision. The conservative pricing of retail and wholesale deposits represents one aspect of their efforts to widen profit margins. In light of concerns about their capital positions, banks and thrifts also have reined in lending activity and imposed stiffer terms on loans.

The change in credit supply conditions may have significant implications for borrowing, spending, and policy. I would not call this change a "credit crunch," as those words connote a contraction of lending on a major scale, with many borrowers effectively shut out of credit markets, regardless of their qualifications. We are not seeing symptoms of that kind of widespread, classic crunch, as in the past when deposit rate ceilings or usury ceilings limited the market's ability to adjust and forced cutoffs of credit. But I can well appreciate that my view on this topic may be perceived as a semantic nicety by a borrower who today is suddenly unable to get a loan on the terms formerly

available To the borrower, it makes little difference why the lender is pulling back or how pervasive the change in credit conditions is

From a policymaker's perspective, however, it is essential to sort the issues out This means discerning the breadth and depth of the shift in credit conditions, its causes, its effects, and the extent to which it may ultimately be a desirable development. Clearly, the verdict is not yet in on the current episode; in economics we are seldom able to make a definitive diagnosis until well after the fact, but to do our job we must hazard some answers

First, what do we observe? The evidence on this score continues to grow; numerous reports indicate that depository institutions and other lenders have become more selective in extending credit. In addition, Federal Reserve surveys of large banks support this sense that terms have been tightened in particular parts of the country and on certain types of loans. Especially hard-hit have been financings for mergers and LBOs, commercial real estate, and construction and development. There also is evidence that small and medium-size companies, as well as the poorer quality credits among the larger firms, have faced some tightening of credit availability. The change in credit conditions has taken various forms, including tougher standards for credit approval, higher collateral requirements, increases in interest rates, and, in some cases, loans have been simply unavailable Even investment-grade corporations appear to be facing slightly higher costs in accessing bank credit facilities At the same time, a huge widening of spreads on less-than-investment-grade bonds has effectively shut down that market to most new issues



But on a number of other types of credit, changes in price and non-price terms appear to have been relatively minor. For example, the rates on residential mortgages, consumer loans, and the debt of investment-grade corporations have remained about in their usual alignment with other market interest rates. Because these credits may trade on securities markets and thereby access a broad range of investors, the interest of banks and thrifts in holding the obligations in portfolio has little, if any, effect on the cost to borrowers. These obligations account for a major share of the credit extended in the economy, and hence the slowing of depository credit and the sluggish behavior of the monetary aggregates--while indicative of some tightening of credit--likely overstate the impact of the depositories' behavior on economic activity.

No doubt a sizable portion of lenders' increased reluctance to commit funds for certain purposes reflects a natural and healthy reaction to a slowdown in growth as the economy moves closer to capacity constraints. Prospects for continued strong production and sales increases fade, and the odds rise that some borrowers will prove unable to meet their obligations. In other words, part of the ongoing shift in credit conditions is what amounts to a regular cyclical event. But there is more to it than that. Through one avenue or another, the change in credit standards has its roots in part in the excesses of the 1980s. The weaker credits extended during that decade have come home to roost, and in so doing have impinged to varying degrees on the current availability of credit.

Perhaps the clearest example is the real estate sector and its principal lender, the thrift industry. Those S&Ls that were the freest with their funds exist no longer, having been closed by the RTC, and the remaining S&Ls face tighter regulations constraining their lending. The resulting void has been filled quite effectively for home mortgage borrowers, with highly developed secondary markets drawing funds in from elsewhere. For these borrowers, the shrinkage of the thrift industry does not represent a significant decline in intermediation services. But many other clients of thrifts, whose debt is less easily securitized, have been hard-pressed to find alternative sources of funds. Moreover, lax lending standards by both thrifts and banks contributed to overbuilding in commercial real estate, which has added to problems for lenders to this industry.

Rising capital requirements for banks and thrifts have interacted with large losses on soured loans and the financial market's distaste for providing additional capital to the institutions taking these losses. This interaction has resulted in strong incentives for depository institutions to conserve capital. Their efforts to build larger capital cushions, in turn, have been manifest in a somewhat more cautious approach to lending, as well as a stepped-up effort to sell off assets by, for example, securitizing loans. Partly as a result of tighter credit conditions, the growth of credit, as measured by the change in the debt of domestic nonfinancial sectors, has come down into closer alignment with the expansion of nominal GNP. This process, which reflects a somewhat more cautious approach on the part of borrowers as well, is not an aberrant restrictive phase in the life of the financial

system, but rather a return to what had been the norm prior to the 1980s

To be sure, when you go from excess credit creation to normal, it can feel like a tightening. And in that sense credit conditions have tightened. Many of the loans made during the 1980s should not, by historical standards of creditworthiness, have been made. As standards reverted closer to normal, those weaker borrowers have been finding it far more difficult to access credit.

In addition, however, depository institutions appear more recently to be lending with greater caution in general. As a result, even creditworthy borrowers may have to look harder for a loan, put up more collateral, or pay a somewhat higher spread. For the nation as a whole, the tightening of credit standards will leave the financial system on a sounder footing and contribute to economic stability in the long run. Nevertheless, in the here and now, the tightening is beginning to have very real, unwelcome effects. Diminished credit availability can constrain firms' spending, for example, limiting more of them to internally generated funds. It is difficult to discern the dividing line between lending standards that are still healthy and those that are so restrictive as to be inconsistent with the borrower's status and the best interests of the lender in the long run. In recent weeks, however, we may have slipped over that line. Such developments can, and do, occur independently of central bank actions, and can have important influences on spending and output. Thus the Federal Reserve must remain alert to the possibility that an adjustment to its posture in reserve markets might be needed to maintain stable overall financial conditions.

As best we can judge, the change in credit conditions currently is exerting a slight additional degree of restraint on the economy. The process of credit restraint may not have reached completion and some of its effects may not yet have been felt, hence it will require continued scrutiny. However, the tightening should eventually unwind as displaced borrowers find alternative sources of funds and as the banking system rebuilds its capital.

This restraint has implications for monetary policy at present, and the ongoing restructuring of the financial system has implications for the conduct of policy over the foreseeable future. It is clear that the financial restructuring will affect the channels through which policy actions are transmitted ultimately to economic growth and inflation; some will be diminished and others augmented. In these circumstances, the Federal Reserve has emphasized a flexible approach to policymaking, which includes attention to a wide range of economic and financial indicators.

#### Ranges for Money and Debt Growth in 1990 and 1991

At its meeting earlier this month, the FOMC reaffirmed the 1990 range of 3 to 7 percent it had set for the growth of M2. With the thrift industry likely to continue to shrink at a good clip and commercial banks expanding more circumspectly, depository institutions are not expected to be bidding aggressively for funds. As a result, although banks may replace more of their managed liabilities with retail deposits, M2 could well remain in the lower half of its target range through year-end. In view of changing credit flows, a slow rate of

expansion in M2 seems consistent with continued moderate growth in output, but any pronounced weakness in the aggregate that drops it below its current range might represent greater monetary restraint than is desirable this year.

Looking ahead to 1991, the Committee lowered the M2 range by 1/2 percentage point on a provisional basis. We believe that this range is consistent with the continuation of measured restraint on aggregate demand--a necessity in the containment, and ultimate elimination, of inflation. Such restraint need not be a barrier to sustained growth. Indeed, it is a crucial requirement. As I suggested earlier, one thing that surely would jeopardize the current expansion would be for inflation to move upward, rather than downward, from the recent plateau.

FOMC members and other Reserve Bank Presidents generally foresee the policy embodied in the money ranges as leading to both sustained growth and diminished inflation in the period ahead. For 1990, their expectations center on an inflation rate in the 4-1/2 to 5 percent range, with real GNP growth of about 1-1/2 to 2 percent. But with this year's slow growth helping to relieve pressures on resources, expectations for 1991 incorporate both somewhat lower inflation and somewhat higher real growth, at a rate closer to that of growth in potential output.

The path of M3 consistent with these projections has been heavily affected by the changes in financial intermediation in recent quarters. Taking into account the current lending posture of the commercial banks and remaining thrifts, we now expect the closures of insolvent thrifts to show through in very subdued growth in M3.

Accordingly, the FOMC voted to lower the 1990 range for growth of this aggregate to 1 to 5 percent. This action does not signal a tighter policy stance, but rather our recognition that financial markets have been adjusting to the RTC's activities in a somewhat different manner than we had anticipated, making the lower M3 target appropriate. In view of the considerable uncertainties about both the scale of RTC activities next year and the speed with which the banking industry will approach a more comfortable capital position, the new 1990 range was carried forward unchanged into 1991 on a tentative basis.

Overall debt growth during the rest of this year is expected to remain around the midpoint of its reaffirmed 5 to 9 percent monitoring range. The nonfederal sectors now appear to be increasing their debt about in line with nominal income growth, with the rapid pace of mortgage borrowing in recent years slowing into the single digits and corporate leveraging activity slackening. Growth of total debt in 1990 is likely to exceed that of nominal GNP, however, as the federal government's borrowing to fund RTC activities is expected to boost the total by roughly 3/4 percentage point.

For 1991, the FOMC has provisionally reduced the monitoring range for domestic nonfinancial sector debt to 4-1/2 to 8-1/2 percent. Debt growth in this range should be adequate to support continued economic expansion, while avoiding the excessive leveraging that characterized much of the 1980s.

A number of uncertainties come into play in the process of judging the outlook for the economy over the next year and a half. Of particular concern in the context of monetary policy are the likely

extent and persistence of the tightening of credit terms, the prospective path of potential output growth--especially in view of the recent slowing in the labor force--and the outlook for fiscal policy. It is the last of these that is the focus of the remainder of my comments today.

#### Fiscal and Monetary Policy Interaction

The determination displayed by the Congress and the Administration in their efforts to come to an agreement on cutting the deficit has been enormously heartening to all who are concerned about the long-run health of the U.S. economy. As a nation, we have been saving too little and borrowing too much; significant progress on the federal deficit would be an important step in rectifying this situation. As you know, I favor not only eliminating the deficit, but also ultimately bringing the government's accounts into surplus over time to compensate for the private sector's tendency to save relatively little. In the long run, the nation's saving and investment behavior is crucial in determining its productivity and hence its standard of living.

Major, substantive, credible cuts in the budget deficit would present the Federal Reserve with a situation that would call for a careful reconsideration of its policy stance. What adjustment might be necessary, and how it might be timed, cannot be spelled out before the fact. The actions required will depend on the constellation of other influences on the economy, the nature and magnitude of the fiscal policy package, and the likely timing of its effects. I can only offer the

assurance that the Federal Reserve will act, as it has in the past, to endeavor to keep the economic expansion on track

Concerns that the Federal Reserve would be unable to offset undesirable macroeconomic effects of a budget pact are, I believe, largely unfounded. It is true that, in general, monetary policy cannot be calibrated extremely finely in response to economic developments, as we are all subject to imperfect data and an imperfect understanding of the myriad economic interrelationships of the real world. However, some doubts seem to focus on whether the various lags involved permit monetary policy to catch up to a change in the fiscal stance. I am less concerned on this point. We can decide that a policy adjustment is appropriate and implement it fully, all in the same morning if need be, and the effects of the change will show through to interest rates and financial asset prices almost immediately. Granted, the impact on economic growth and inflation will be spread out over several quarters, but this is true of changes in fiscal policy as well.

In the final analysis, no one can guarantee that growth in the economy will proceed smoothly, without a hitch on a quarter-to-quarter basis. Nevertheless, a major cut in the budget is unquestionably the right thing to do. Because the federal government has been borrowing too much for too long, it is well past time to reduce the government's draw on credit markets and to free up more resources for enhancing investment and production by the private sector. In this way, fiscal policy, by augmenting national saving, will be doing its part to promote maximum sustainable economic growth. With monetary policy similarly keeping sight of its long-run goal of price stability, the two



together will have set a favorable backdrop for vibrant and enduring economic growth