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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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Mr  Chairman, it is a pleasure to be here today to discuss the state of the economy and the appropriate course for policy in the current situation

When I presented the Federal Reserve's semiannual report on monetary policy to the Congress in July, I noted that the pace of economic activity had slowed considerably this year.  Real GNP rose at only a 1-1/2 percent annual rate, on average, in the first half, and the available indicators suggest that real growth remained slow during the summer   Private employment has been flat over the past two months, and the unemployment rate, which had fluctuated narrowly for several quarters, has edged up since midyear

Despite the general sluggishness in business activity this year, the underlying trend in inflation has not improved.  In fact, the core rate of inflation in consumer prices may have crept higher Moreover, the chance of a significant break soon in the inflation trend would seem to have diminished in view of the additional pressures from oil prices

In my July testimony, I noted that the Board members and Reserve Bank presidents expected the economy to expand at a moderate pace over the ensuing year and a half, while prices were anticipated to rise less rapidly than they had earlier this year   Most private forecasters shared that assessment   Regrettably, events in the Middle East have introduced new and substantial risks to the outlook   The higher oil prices already have added to overall price pressures and may have begun to restrain real activity.  In addition to the effects of the higher oil prices per se, just the enormous uncertainty about how and

when the tensions in the Persian Gulf will be resolved undoubtedly is affecting the economy in a negative way.

If we knew how oil prices were going to move in coming months, it would be feasible--at least in principle--to trace out the effects of the 1990 "oil shock" on the U S economy Economic theory supplies an analytical framework, and empirical analyses of past experience provide rough indications of the likely direction and size of the impacts

Admittedly, even the most sophisticated econometric models are simplified, almost crude, representations of economic reality They vary in their readings of history and cannot capture completely the scope and complexity of the economy's interrelationships or changes in its structure over time. Moreover, they cannot take into account the political and military unknowns in the current situation Nonetheless, such models can be employed to identify the directions, and rough orders of magnitude, of the average effects of changes in oil prices This is certainly a useful first step in policy analysis

Suppose, for example, that crude oil prices were to average something under $30 per barrel over the next year--roughly in line with what is suggested by current transactions in the spot and futures markets This would be approximately $10 per barrel above their July level Representative models suggest that such a $10 per barrel increase in the price of oil would add 1-1/2 to 2 percent to the level of overall consumer prices over the next year. Much of the increase in the overall price level reflects the pass-through of higher costs of crude oil into prices of domestically consumed petroleum products These direct effects typically appear relatively quickly; indeed, such

effects already were evident in yesterday's report on the CPI for August and undoubtedly will remain sizable in the September figures as well Other, less direct, effects will build over time Prices for competing energy products will be bid up, and those of goods and services that use energy as an input will rise more rapidly than they otherwise would have A sustained higher oil price also would tend to feed through--with some lag--to wages, as workers seek to offset losses in their real income

The effects on economic activity work through several channels and are more difficult to sort out The range of empirical estimates is doubtless wider than for prices, but a representative figure is that a sustained increase of $10 per barrel of oil would reduce the level of real GNP by roughly 1 percent within a year Much of this loss in output arises because--to the extent that the United States is a net importer of oil--a hike in oil prices drains away purchasing power from American energy users to foreign oil producers Indeed, with imports of petroleum and products currently averaging about 8-1/2 million barrels per day, a $10 per barrel rise in the oil price adds roughly $30 billion to our annual import bill

Specifically, the higher consumer prices that result from the oil shock cut into the real disposable income of households, which in turn can be expected to reduce their spending The weaker path for consumption subsequently can be presumed to spill over to business investment as many firms--their profit margins already squeezed by higher energy costs--lower capital spending in response to the reduced demand for their output.

Over time, the oil-producing countries may increase their purchases of U S -produced goods and services In the current situation, the recent fall in the dollar may also provide some stimulus to our exports and restrain our imports But, in total, the increment to U.S GNP from higher net exports probably will be smaller than the drop in domestic demand--particularly in the short run. In addition, the weaker dollar adds upward pressure to U S import prices and hence raises further concern about inflation and instability.

Domestic energy producers, like their foreign counterparts, benefit from higher oil prices At least to some extent, they likely will increase spending on exploration and drilling, or other types of investment Nonetheless, this offset, too, probably will be relatively small in the near term, as producers--not knowing whether the higher oil price will be sustained--are likely to be reluctant to undertake major projects.

Turning from the abstract to the current reality, hard data on the output of goods and services in the period since the invasion of Kuwait are limited, and it is difficult to distinguish the effects of higher oil prices from developments that would have occurred anyway. Clearly, growth is, at best, sluggish. Nonetheless, judging from both hard data and more anecdotal reports, we are not--at least as yet--witnessing a cumulative unwinding of economic activity.

Outlays on new cars and light trucks should be sensitive to the uncertainty shock that the Persian Gulf crisis has imparted, yet they have softened only moderately from the pace of earlier in the summer In addition, the advance estimates for August suggest that retail sales

of other items were about the same in real terms as in the preceding few months. Nonetheless, prospects for consumer demand are highly uncertain, especially in light of the sharp deterioration in consumer sentiment recorded in a variety of surveys since the Middle East crisis began. For example, the indexes compiled by the Survey Research Center at the University of Michigan and by the Conference Board both plummeted in August to their lowest levels since 1983.

As yet, there is no statistical evidence on how prospects for business investment may have changed as a consequence of the oil shock. But the available anecdotal information clearly has taken on a more pessimistic tone over the past several weeks. Notably, the latest information provided to the Federal Reserve Banks by businesses and other contacts suggests a greater caution on the part of firms in the acquisition of capital goods, in some cases because of increased uncertainty. The reports from the District Banks are summarized in the so-called "Beige Book," which will be released later today.

It would be surprising if the recent developments did *not* give rise to some pull-back by consumers and businesses. But the paucity of hard data makes it difficult to assess the extent of any cutbacks in spending or production that may be under way. It is also difficult to put the information in perspective. For example, the sharp drop in consumer attitudes may be largely a reflexive response to bad news, rather than an objective assessment of the outlook for income and employment. If so, attitudes, and spending in turn, may improve, once the initial shock effect wears off. On the other hand, the surveys may be signalling a more basic weakness in demand that will not be eased by

the mere passage of time. The prospects for weakness cascading throughout the economy do not as yet appear compelling, in part because of the tight rein that businesses have been keeping on inventories Nonetheless, we must remain alert to the possibility of such a development

Whether an efficacious policy response to current developments would seek higher, lower, or unchanged interest rates will depend on the specifics of the situation, which are shifting day by day In framing policy, however, we must not lose sight of the fact that there is no policy initiative that can in the end prevent the transfer of wealth, and cut in our standard of living, that stems from higher prices for imported oil In addition, we must take into account the policy problems that already were present before the oil shock. For example, as I reported to the Congress in July, we made an adjustment to policy at that time in response to evidence, including Federal Reserve surveys, that banks--along with other lenders--had tightened credit Data since that time have validated the earlier assessment, and, of course, we shall continue to evaluate all of the evidence relating to credit conditions

Another key issue one must address is how much of any change in short-term rates would carry over to the crucially important long-term rates, given the concern in financial markets about prospects for inflation and about future economic developments It is lower long-term rates, rather than short rates, that can do the most to foster the investment activity that is critical for the future health of the economy Specifically, lower mortgage rates clearly would be useful in

containing the current erosion of real estate markets. Policy actions that are not perceived to be consistent with a stable, noninflationary economic environment could easily be counterproductive over the long haul.

It is the responsibility of monetary policy to look through the uncertainty of the near term and to provide the stable financial environment that is consistent with our longer-run objectives We shall want, for example, to make sure that money and credit remain on appropriate growth tracks, with due allowance for the special influences affecting the demand for money and its velocity, among those influences are the credit developments to which I referred a moment ago Indeed, one could argue that the restrained stance of monetary policy over the past few years may have reduced the odds of the oil shock igniting a more general acceleration of prices and a sharp escalation of bond yields

In any event, the surest way to bring down real long-term interest rates is to reduce the federal budget deficit. As you know, some have expressed concern in recent weeks that a large cut in the FY1991 budget--coming on top of the oil shock--would risk tipping the economy into recession Such fears are understandable; however, they must be balanced against the benefits that will flow from reducing the federal government's claim on the nation's limited pool of saving Because the government has been borrowing so much and for so long, it is well past time to scale back its draw on credit markets and to free up more resources for enhancing investment and production by the private sector

The participants in the Budget Summit are endeavoring to craft a package of sizable deficit reductions If they succeed and the Congress does enact a credible, long-term, enforceable budget agreement, I would expect long-term interest rates to decline

In that context, I would presume that the Federal Reserve would move toward ease to accommodate those changes in the capital markets. What adjustment might be necessary, and how it might be timed, cannot be spelled out before the fact The actions required will depend on current economic conditions, the nature and magnitude of the fiscal package, and the likely timing of its effects

In the final analysis, no one can guarantee that real growth will proceed smoothly, without a hitch on a quarter-to-quarter basis I can only offer the assurance that the Federal Reserve will seek, as we have in the past, to foster economic stability and sustainable growth, in the context of continued progress over time toward price stability