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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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U.S. House of Representatives

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Mr. Chairman and members of the Committee, I appreciate the opportunity to participate in your examination of the economic implications of developments in the Persian Gulf

The world economy is being profoundly influenced by these developments, including their effects on oil markets during the past four months However, before turning to an examination of the effects of higher oil prices on the U S. and world economy, it is useful to step back for a moment and review the trends that our economy appeared to be following prior to the Iraqi invasion of Kuwait. On the positive side, the data released in recent weeks have confirmed that the economy was still expanding when the oil shock hit. Indeed, real GNP currently is estimated by the Commerce Department to have increased in the third quarter. In addition, the index of industrial production increased at a 3.7 percent annual rate last quarter, indicating that much of the strength in the economy during the summer was in the goods-producing sectors, where a weakening of overall activity typically would be expected to show through most clearly. On the negative side, however, growth of private payrolls was at a virtual standstill in July, and the unemployment rate, which had fluctuated narrowly for several quarters, began to rise around midyear, albeit from a level that was quite low by recent historical standards.

On the inflation front, data through July suggest that price increases had not yet begun to decelerate as of mid-summer In fact, there were disturbing signs in the first half of the year that the core rate of inflation had crept up somewhat. However, the latest data on hourly compensation hint that labor cost increases were beginning to

slow in the third quarter, and, had oil prices not jumped after August 2, some easing of underlying price pressures might well have become evident by now.

To summarize, Mr. Chairman: The data that we have received during the past four months indicate that, prior to August 2, the economy was expanding at a moderate pace and underlying inflation pressures probably were beginning to ease. This suggests that things were developing in line with our policy objectives, which were to achieve a slowing of inflation in the context of continued expansion of real activity

Regrettably, however, the events in the Persian Gulf have altered the immediate economic situation rather substantially. Consumer and producer price indexes have jumped in the past couple of months because of surges in the prices of energy products Other, less direct, effects are becoming evident as the higher oil costs are being passed through into the prices of items that are heavily dependent on oil-- notably airline fares and other transportation costs and materials that rely heavily on petroleum feedstocks Over time, the higher prices may feed through to labor costs, as workers seek to delay the inevitable declines in their real incomes These same influences are being felt, in one degree or another, in most other economies regardless of whether they are net oil importers or net oil exporters.

Not only have the higher oil prices added to overall price pressures here and abroad, they also have begun to restrain real activity These effects work through several channels and are difficult to sort out with great precision First, 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 Specifically, the higher prices cut into the real disposable income of households, which in turn reduces their spending on all categories of goods and services. Second, the weaker path for consumption subsequently is likely 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.

In addition to the effects of the higher oil prices *per se*, the enormous uncertainty about how, and when, the tensions in the Persian Gulf will be resolved also affects the economy in a negative way. Such uncertainty tends to engender withdrawal by producers and consumers from their normal activities as they respond cautiously to new developments However, the surveys of people's concerns about the outlook have pointed to greater weakness than has been revealed by what people, at least to date, are actually doing.

Most of these same influences on prices and activity are affecting the economies of our major trading partners. Although countries that are not net oil importers, such as Canada and the United Kingdom, do not face the net drain on real national income from higher oil prices, they are adversely affected by economic developments in the oil-importing countries and by higher oil prices which tend to depress real personal income, at least in the short run Consumers and producers in these countries are also affected by the uncertainties

surrounding the entire situation. All this has negative feedback effects on our own economy through lower exports.

In the current episode, the clearest manifestation of the actual effects on U.S. activity is in the labor market, where private employment and hours of work dropped markedly in October, and where initial claims for unemployment insurance have moved significantly higher over the past several weeks. In addition, industrial production--especially in the motor vehicle and construction supplies sectors--fell in October, and the weekly data through mid-November point to pronounced further weakness The drop in employment and hours is causing personal income to decline at the very time that rising energy prices are squeezing many household budgets, this drop in real purchasing power, along with plunging consumer sentiment, does not bode well for the near-term trends in consumer demand especially in the context of an already-low saving rate. It is noteworthy that retail sales in October were about unchanged in nominal terms, and undoubtedly fell significantly in real terms.

Higher oil prices, however, are not the only force restraining activity In particular, as I reported to the Congress in July, there was considerable evidence at that time that banks--along with other lenders--had tightened the terms and other conditions for supplying credit. Data since then, including Federal Reserve surveys of bank lending officers as well as the recent sluggishness of the monetary aggregates, suggest that the tightening of credit has proceeded somewhat further since July

As yet, there is only limited statistical evidence on the extent to which tighter credit conditions have directly affected businesses and consumers. However, the available anecdotal information clearly suggests that many types of businesses are encountering greater difficulty obtaining financing This has been seen most clearly in the commercial real estate market, but it extends to borrowing for a variety of other purposes as well

The interaction of rising oil prices, Persian Gulf uncertainties, and credit tightening is apparently creating a greater suppression of economic activity than the sum of the forces individually. Thus, although economic activity seems to have been better maintained through the summer than many forecasters had expected, all indications are that a meaningful downturn in aggregate output occurred as we moved through October and into November

Amidst these adverse developments, the depreciation of the dollar we've seen this year, other influences aside, may be expected to provide some stimulus to our exports and restrain our imports. However, a weaker dollar also is a cause for concern: It adds upward pressure to U.S. import prices, compounds the inflation impulse emanating from the higher oil prices, and may put at risk our ready access to net inflows of foreign saving

In the oil market itself, rates of overall production of crude petroleum currently appear to have been restored to pre-crisis levels, after a temporary disruption in the wake of the Iraqi invasion At the end of July, OPEC had agreed to reduce its production rate from about 23-1/2 million barrels per day to 22-1/2 million barrels per day

Before the new accord could take hold, of course, Iraq invaded Kuwait. The subsequent United Nations-sanctioned embargo removed 4.3 million barrels per day of Iraqi and Kuwaiti crude oil production from the market, an amount equal to almost 10 percent of production in market economies.

This loss has since been fully replaced through increased liftings by other members of OPEC, chiefly Saudi Arabia, as well as significantly increased production in the North Sea. As a result, in October, crude production in market economies was back up to about the same rate as during the first half of this year, almost 46 million barrels per day. Although the replacement crudes are slightly "heavier" than the lost oil, and therefore yield less output of light products such as gasoline and kerosene, such differences appear manageable

While the response of world crude oil production to the Iraqi invasion can be gauged fairly readily, the reaction of world oil consumption is more difficult to discern. Available data on world shipments of petroleum products actually show a greater-than-normal increase in the third quarter. But a substantial portion of this increase is thought to have been reflected in secondary and tertiary stockbuilding, rather than in an increase in actual consumption Secondary stocks, incidentally, are those held by product retailers and distributors, while tertiary stocks are held at the point of consumption, such as industrial plants

Primary commercial stocks of petroleum and products held on land by refiners and marketers in the industrial countries appear to be a bit above normal for this time of year In addition, rough indicators

of the level of stocks afloat suggest that after a small decline in the third quarter, these stocks may be increasing. Some of these stocks, which are held in ocean tankers, represent unsold heavier crude oil from Saudi Arabia and Iran. Overall, world stocks of petroleum and products currently are at levels that, under normal circumstances, probably would be viewed as being comfortable or perhaps even slightly excessive. This relatively comfortable situation is consistent with the current pattern of futures prices, which show a decline of about $6 to $8 a barrel by the second half of next year from the recent spot price levels of about $33 per barrel for West Texas intermediate crudes. Indeed, at the current apparent balance of supply and demand for crude oil, spot prices might have been expected to be substantially lower were it not for the uncertainties associated with the situation in the Gulf. What we have seen in varying degrees since August 2 is a general scramble for existing inventories by refiners here and abroad to guard against a possible further short-term disruption of supplies. This has contributed to the bidding up of prices on spot markets

The situation in markets for a few specific oil derivatives may be somewhat tighter than in markets for crude The shutdown and blockade of refineries in Kuwait and Iraq removed about 2 percent of the world's refinery capacity from the market The lighter-end products, such as kerosene or jet fuel, produced by these refineries went primarily to Japan and other Asian countries. Attempts by Asian consumers to replace the lost products, coupled with increased Gulf-related military demand, resulted in a bidding-up of world kerosene and jet fuel prices during September and October relative to crude and other

petroleum products. But these spreads have since retraced most of their earlier increase. At the time of the invasion, refineries in Western Europe had been operating at relatively low utilization rates, and there appeared to be some excess capacity, globally, in operations that convert heavier products into lighter ones Production rates have presumably risen in these areas since the invasion.

In the United States, gasoline markets were relatively tight over the period prior to the invasion, owing to strong demand and a series of disruptions at refineries Stocks of gasoline fell further in August, rebounded through September and the first half of October, and have edged off over the past six weeks The level of stocks last week was roughly in line with its level a year ago, and about 6 percent above what is considered the minimum operating inventory required to ensure against normal operating problems and shortages.

The rapid rise in crude oil prices following the Iraqi invasion helped boost the domestic average price of gasoline from $1.10 per gallon in the second quarter to an average of roughly $1.40 per gallon during the past two months. However, average margins between the cost of crude to refiners and retail prices at the pump fell significantly from July through October Recently, margins have recovered somewhat, but they still appear to be about 5 to 10 cents per gallon below their average level in the second quarter this year.

Turning to the question of how the Gulf crisis has affected monetary policy, the first point is that the uncertainties surrounding the situation are considerable and that it is difficult to isolate the Federal Reserve's response to this particular event when so many other

things are affecting the policy equation. Moreover, 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.

The role of monetary policy is to provide the financial environment that is consistent with the nation's longer-run economic objectives. Since the spring of 1989 this has implied some easing of reserve conditions, and the federal funds rate has come down from near 10 percent to its current level of around 7-1/2 percent. Our latest policy adjustments have been in response to indications of a weaker economy, partly as a consequence of the prospects for a degree of fiscal restraint as a result of the budget agreement, and partly because of some further tightening in the availability of credit since mid-summer In this context, we shall want to make certain that money and credit remain on appropriate growth tracks, with due attention to the credit situation. Whether further adjustments to policy will be needed cannot be spelled out in advance and will depend on the specifics of the circumstances as they develop

In the final analysis, 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 As in the past, this will require not only attention to the level of economic activity but also the pursuit over time of price stability--a task made all the more challenging by the effects of the Gulf crisis