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Testimony by

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Mr Chairman, I am pleased to be here today As you know, the Federal Reserve will submit its semiannual report on monetary policy to the Congress next month. That report will cover in detail the System's policy targets for 1991, as well as our expectations for growth and inflation. I'm sure you can understand that I would be reluctant to anticipate those projections even under normal circumstances, but these are far from normal circumstances, and clearly we shall be in a better position to address the outlook with greater precision once some of the uncertainties associated with the Gulf conflict have been resolved I do think, however, that we can focus productively today on some of the other considerations bearing on our nation's economic prospects and on the appropriate course for policy in the current environment

All indications are that business activity declined appreciably in the fourth quarter of 1990 When I appeared before the House Banking Committee in November, I noted that aggregate output had turned down as we moved through October and into November The contraction apparently continued in December. In the labor market, payroll employment fell another 75,000, after even bigger declines in the preceding two months, and the civilian unemployment rate rose further, to 6 1 percent Manufacturing output continued to fall rapidly, and the index of industrial production is estimated to have dropped another 0 6 percent

The December drop in industrial production brings the total decline since September to around 3 percent Close to half of that decline is attributable to cutbacks in the output of motor vehicles and parts, and production of construction supplies also has been exceptionally weak Reductions have occurred elsewhere as well

Events in the Persian Gulf clearly were a key factor in explaining why business activity weakened so markedly this past autumn. Specifically, the jump in prices of petroleum products cut into the real disposable income of households and thus contributed to the softness in spending for a wide range of goods and services Moreover, many firms, whose profit margins already were being squeezed by higher energy costs, curbed production to prevent inventory buildups; and they have trimmed capital spending plans in response to actual or expected reductions in the demand for their output in the wake of the energy price hikes

But the damage from the Persian Gulf crisis went beyond the direct effect of higher oil prices Indeed, the enormous uncertainty about how, and when, it would be resolved contributed to a marked erosion of consumer and business confidence about prospects for the economy Faced with such uncertainty, producers and consumers tend to withdraw from their normal activities while they wait for clearer signals of economic developments and avoid making commitments that might be costly to reverse

Of course, the crisis in the Persian Gulf was not the only factor restraining activity In particular, the evidence suggests that banks--along with other lenders--have tightened the terms and other conditions for supplying credit, and some borrowers undoubtedly have encountered greater difficulty obtaining financing. Such difficulties are clearest in the commercial real estate market, but they extend to borrowing for a variety of other purposes as well

Assessing the economic outlook is especially daunting at the present time--and not solely because of the enormous uncertainties

surrounding the war in the Persian Gulf. To be sure, the information on economic activity in recent weeks is extremely limited But as best we can judge, the latest data contain some hints that the effects of the initial shock last August have largely worked their way through the system and that the downward pressures on activity may be lessening Nonetheless, we must also recognize the possibility that overall activity may decline further before an upturn takes hold. Such an outcome could result if, for example, the serious weakness in some parts of the country were to spread to regions where activity is stronger or, alternatively, if consumer and business confidence has been so shaken by events since August that further reductions in spending are in store

Clearly, problems in real estate markets will be a drag on the economy for a time, especially in view of the role they have played in exacerbating the difficulties financial institutions face In the residential sector, concern about home prices and worries over job and income prospects seem to be deterring potential homebuyers--although, with mortgage rates down, homes are more affordable than they have been in some time In the commercial sector, the overhang of vacant space remains heavy despite the reductions to date in new construction Granted, outlays for office and other commercial buildings amount to only about 1 percent of GNP, and thus the direct effects on overall economic activity of even a sharp contraction in new construction are limited Nevertheless, because existing commercial properties constitute such a large share of the stock of assets that have to be financed, a deep drop in the value of existing buildings implies sizable

losses on the balance sheets of banks and other financial institutions, with repercussions that extend beyond the construction industry

At the same time, other factors support optimism about the outlook for activity. First, the depreciation of the dollar over the past year should buoy the growth of exports, even in the face of some slowing of economic expansion abroad It also should help to restrain imports, and thus to shift some domestic demand to U S. producers Of course, this is not to imply that the lower dollar is entirely a blessing· It adds to inflation pressures, and it may contribute to instability in financial markets.

One feature of developments to date that bodes especially well for activity is the apparent rapidity with which producers have responded to the anticipated weakness in demand. The data in hand are scanty and subject to revision, but at this stage, overhangs of inventories appear isolated and more manageable than they typically were in cyclical downturns in the past Thus, if final sales hold up--and I am not fully confident we can assume that they will--much of the production adjustment could be behind us Moreover, any strengthening in final demand would likely translate quickly into a pickup in output.

The automakers are a key example of this behavior· They were quick to slash assemblies even though sales had dropped rather moderately and even though dealer stocks did not appear excessive by historical standards. To be sure, underlying demand was weaker than the reported sales, which included sizable purchases by the big rental firms, and the inventory figures must be evaluated in light of the prospect that many of these cars will reenter the market as "nearly new"

in just a few months But the reductions in motor vehicle output late last year were prompt and substantial All else equal, they were large enough to cut more than 2 percentage points from the annual rate of real GNP growth in the fourth quarter. The good news is that most, if not all, of the reduction in motor vehicle output may well be behind us, judging by current production schedules for the first quarter

On the inflation side, apart from the uncertainties associated with energy prices, the outlook seems to have improved over the past few months A good many signs point to an easing of wage pressures, and some further diminution in wage inflation seems likely in the context of the slack that has emerged in labor markets in recent months. In addition, the core rate of inflation in consumer prices over the past several months has been running below that recorded earlier in the year

Against this background, the Federal Reserve has extended a series of steps taken over the past year and a half to ease the stance of monetary policy Reflecting these actions, the federal funds rate has come down about 3 percentage points, on balance, since the spring of 1989, from almost 10 percent to around 6-3/4 percent Other short-term rates have fallen appreciably as well, and long-term Treasury bond rates are near the low end of their range for the last year.

The conduct of monetary policy over this period has involved a careful balancing of the need to respond to signs that economic activity was slowing perceptibly, on the one hand, and the need to contain inflationary pressures on the other The initial easing actions, taken between June and December of 1989, were largely a response to developments that began to suggest that a slackening in inflation might

be in prospect as indications of slower economic expansion continued to accumulate and money growth remained sluggish relative to the annual ranges Policy was little changed, on net, in the first part of 1990, as economic activity appeared to be well-maintained--albeit at a subdued pace--but the inflation news was disappointing

By midyear, there were hints of moderation in inflation after the earlier spurt, and incoming information pointed to sluggishness in economic activity In addition, restriction on credit supplies at banks, signaled in part by lagging money growth, suggested that credit conditions were tighter than intended, and thus policy was eased a notch over the summer

Further actions have been taken in light of your fiscal actions last fall, the weakening economy, continuing problems of credit availability, and slow growth in the money aggregates They include a cut of 1/2 percentage point in the discount rate in mid-December to 6-1/2 percent, a reduction in certain required reserve ratios, and other operations designed to make reserves more available

We expect that our actions to date will provide support to economic activity in the quarters ahead. Whether further adjustments to policy will be needed is not known, decisions on that score will depend on developing trends in financial markets and the economy In that regard, we shall want to make certain that money and credit remain on suitable growth tracks We are particularly concerned by the sluggishness of the money stock in recent months, and our most recent action was triggered in large part by further evidence of weak monetary growth. In addition, we are monitoring the credit situation carefully,

and we shall continue to review the economic data for signs that the recession might be deepening At the same time, we must take care to avoid a policy that is overly stimulative The amount of slack in the economy is not great by historical standards, and an overly aggressive monetary easing could end up being counterproductive. Our aim should be to encourage a sustainable recovery, rather than one that simply fosters imbalances that will lead to the next downturn

Fiscal policymakers also will have to grapple with difficult decisions in the months ahead I anticipate that the economic forecasts of the Congressional Budget Office and the Administration will show declines in real GNP in both the fourth quarter of 1990 and the first quarter of 1991 In that case, the Senate will be required--and the House have the option--to consider a joint resolution suspending the enforcement provisions of the budget reconciliation act

Voting to suspend the enforcement provisions in the absence of compelling evidence of a deep or prolonged recession would be a mistake. Together with the Administration, you worked long and hard last year to assemble an acceptable package of spending and tax changes and budget process reforms By enacting the budget agreement, you gave financial markets some assurance of stability and of future easing of federal credit demands Undercutting this commitment now might have adverse effects on long-term interest rates and thus might well be self-defeating

I recognize that you are likely to face considerable pressure to take actions that would, in effect, expand the budget deficit Concerns about the appropriateness of a policy of fiscal restraint in a

period of weak economic performance are understandable However, they must be balanced against the benefits that will flow from adhering to a budget strategy that is geared to the longer-run needs of the economy Those needs can best be met by ensuring that the underlying or "structural" deficit remains on a downward track, even as the actual deficit is being swollen temporarily by the effects of the weak economy

In addition, even in the absence of policy actions, the budget will have a substantial stabilizing effect on the economy--something clearly anticipated when the new budget procedures were designed Among other things, the focus on the reduction in the deficit brought about by legislative action, rather than the level of the deficit per se, eliminates the need for policy adjustments to offset the effects of changes in economic conditions and thus allows the automatic stabilizers to function as intended

Moreover, the historical evidence on the implementation of discretionary countercyclical fiscal policy is not encouraging Often in the past, we have adopted programs that were designed to stimulate the economy but that did not come on stream until well after the recovery was under way. If the predominant economic forecast for 1991 is roughly correct, taking stimulative action now may bring on a repetition of that pattern In that case, little would have been accomplished in terms of alleviating our current difficulties, while prospects for increases in capital accumulation and improvements in productivity would have been set back

Furthermore, Operation Desert Storm is not subject to the cap on defense spending, and FY1991 defense outlays undoubtedly will be

considerably higher than was anticipated last fall Other nations are expected to share in the cost of the war, and their contributions will help to cushion the effect on the budget deficit. But regardless of who is paying for it, Desert Storm spending on newly produced domestic items will boost U.S. GNP.

The problems of the deposit insurance system also must be addressed, they, too, have implications for the budget and complicate the interpretation of fiscal policy Under the new budget procedures, net outlays for deposit insurance will continue to be reflected in the official on-budget figures, as well as in the broader measures of the unified budget The inclusion of deposit insurance in the budget totals reduces the usefulness of the unified budget as an indicator of the effect of the federal budget on the economy Because deposit insurance alters the incentives for the managers of financial institutions, it undoubtedly has had significant effects on the real economy, but the actual payouts have little further effect on credit markets, interest rates, or economic activity

Thus, attention should focus on budget figures that exclude deposit insurance, these include the alternative measure of the deficit that the CBO highlighted in its Interim Assessment of the 1990 Budget Agreement and the deficit as recorded in the National Income and Product Accounts (NIPA) Although the NIPA budget is similar to the unified budget in many respects, it treats the lending and financial activities of the federal sector in a way that is more useful for the analysis of the balance of saving and investment and the effects of fiscal policy on economic activity Specifically, it reflects the interest paid or

received in the course of financial transactions, but it excludes the transactions themselves

The rationale is that the National Income and Product Accounts measure the nation's current income and production, and therefore exclude transactions that are essentially an exchange of existing assets and liabilities. Such transactions affect the allocation and distribution of income and output and thus can have a significant economic impact, but they are analyzed more appropriately within a financial-market framework Outlays for deposit insurance are essentially a liquidation of financial liabilities that were incurred earlier They do not represent current income to their recipients, depositors do not become wealthier at the moment that their bank or savings and loan institution is taken over by the government Thus, they are excluded from the NIPA

The credit reform provisions in the budget reconciliation act improve the unified budget accounting for new loans and loan guarantees and narrow the conceptual gap between the two budget measures The legislation also directed OMB and CBO to study the budgetary treatment of deposit insurance, but, for the time being, it remains on a cash basis Outlays for deposit insurance caused a sizable divergence between the NIPA and unified deficits in FY1990; and they undoubtedly will differ substantially in 1991 and 1992 as well Accordingly, it will be especially important to monitor and to understand the NIPA budget measure, which is designed specifically to provide information on how fiscal policy is affecting the economy

The uncertainties in the current situation are great, and the risks of making policy mistakes are high We must, of course, remain alert to events in the Persian Gulf and to their repercussions for the U.S economy But we must also make sure that our policies remain consistent with the achievement of our economic goals for the longer run.