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Testimony by

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Chairman

Board of Governors of the Federal Reserve System

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Mr Chairman and members of the Committee, I am pleased to appear before you again at these monetary policy oversight hearings. As is the convention on these occasions, I shall focus my remarks this morning on monetary policy and the current situation in the economy. However, the events of the past year have once again underlined the ways in which the state of our nation's banking system can affect the transmission of monetary policy to the economy. Consequently, I think I should comment at least briefly on some of the regulatory issues bearing on the willingness of banks to extend credit.

I should like to start, however, with an overview of the economic outlook. As you know, business activity turned down in the latter months of 1990, and appeared still to be declining through the early part of February. With the unpredictability of events in the Middle East compounding the usual uncertainties attending any economic projection, it would be most unwise to rule out the possibility that the recession may become more serious than already is apparent. Nonetheless, the balance of forces does appear to suggest that this downturn could well prove shorter and shallower than most prior post-war recessions. An important reason for this assessment is that one of the most negative economic impacts of the Gulf war--the run-up in oil prices--has been reversed. Another is that the substantial decline in interest rates over the past year and a half--especially in the past several months--should ameliorate the contractionary effects of the crisis in the Gulf and of tighter credit availability.

The major danger to a near-term recovery is that the erosion in purchasing power and frayed consumer and business confidence stemming from the recession and war could interact with a weakened financial system to produce a further decline in the economy. The recent actions we have taken, along with the ranges for growth of money and credit this year, which I shall be discussing in a moment, were designed to reduce the probability of such an outcome and to support a resumption of sustainable economic growth, in the context of progress toward price stability.

Economic and Monetary Policy Developments in 1990 and Early 1991

When I last testified on our monetary policy objectives in July, the economy appeared likely to continue growing, though moderately. The objective of restoring a clear downward tilt to the path of underlying inflation while maintaining the economic expansion thus seemed attainable. Indeed, data that became available subsequently indicated behavior of economic activity in the third quarter consistent with that appraisal.

That said, evidence in July of weaknesses in certain regions and sectors of the economy signalled caution. Notably, deteriorating market conditions for commercial real estate were limiting the ability of some borrowers to service loans, which, along with the restructuring of thrift institutions, induced lenders to pull back from extending credit to this sector. Banks also were becoming less willing to make business loans--not only for highly leveraged transactions, but more generally where industry or local economic conditions looked at all

unfavorable Tendencies toward such restraint, which might normally have been expected in a time of uneven and generally less robust business prospects, were exacerbated by pressures on the capital positions of many institutions In mid-July, to better ensure the economy's continued growth, the Federal Reserve adopted a slightly more accommodative stance in reserve markets to counter the potential effect on spending of this tightening of credit terms at depository institutions

The invasion of Kuwait in early August dramatically altered the economic landscape Oil prices surged, simultaneously worsening prospects for both real income and inflation The higher world oil prices transferred domestic purchasing power to foreign oil exporters, while uncertainties about how the crisis would be resolved shook household and business confidence After the invasion, spending held up for a time before starting to soften, while the jump in oil prices fed through quickly to energy prices more generally and to measures of overall inflation Amid considerable volatility in financial markets and concern about the inflation outlook, bond rates moved back up and stock prices moved down, as many investors shifted to more liquid instruments Treasury bill rates eased, and a surge in purchases of money market mutual fund shares boosted growth of the broader monetary aggregates in August and September

Oil prices, which peaked at more than \$40 per barrel in early October, seemed to be the primary source of financial market uncertainty and volatility, however, the fitful progress toward agreement on measures to reduce the federal deficit also contributed. When the budget

accord was finally reached in late October, its promise of fiscal restraint over the next several years was reflected in somewhat lower bond yields. Against a backdrop of weakening economic activity and in light of the passage of the multi-year deficit-reduction package, the Federal Reserve again eased money market conditions.

This policy action proved to be only the first of a series of easing moves extending through early this month. These moves were prompted in part by subsequent information pointing to sizable contractions of consumer outlays and economic activity stemming from the marked weakening of consumer confidence and purchasing power. They also were taken in response to a lessening of wage and price pressures and decidedly sluggish growth in the monetary aggregates after their surge in August and September. Following continued moderate expansion in the third quarter, real GNP turned downward, led by the decline in consumer spending, but also reflecting reduced construction activity and business inventory investment. Industrial production began a rapid descent in October, with the motor vehicle industry accounting for an especially large share of the drop. Private employment also started to fall steeply, and the unemployment rate rose further. The associated rise in layoffs brought increased uncertainty to the household sector, which in turn has kept consumer spending subdued.

The widening economic slack helped prevent the energy price surge from becoming embedded in ongoing wage and price inflation. The increases in nominal wages and broader compensation measures diminished in the fourth quarter, after exhibiting initial signs of slowing in the

preceding three months. In September, the non-energy component of the Consumer Price Index began to rise at a slower pace. And in the final two months of the year, inflation in the overall CPI fell back, as energy prices topped out in November and declined in December in the wake of lower crude oil prices. The success of Coalition military operations after the outbreak of war in mid-January was seen in oil markets as reducing the odds of wide-ranging supply disruptions, and oil prices retreated still more, further improving the near-term outlook for inflation.

This reduction of cost and price pressures has given the Federal Reserve scope to move aggressively to counter contractionary influences on the economy without contributing to market concerns about the inflation outlook. Absent such a lessening of price pressures, monetary policy easing probably would have risked a heightening of inflation expectations, which could have put the foreign exchange value of the dollar under severe downward pressure and fed through to long-term interest rates, perhaps even pushing them higher.

The easing of policy also was keyed to the meager expansion since September of the broader monetary aggregates. As I shall be discussing more fully, the slowdown in money growth was worrisome because it seemed to reflect a further tightening of credit availability as well as the weakening in spending. The surfacing of additional asset quality problems has heightened financial strains on many banking institutions, placing pressures on capital positions and boosting funding costs. In turn, banks have progressively tightened their standards

for granting loans and have set still more restrictive terms and conditions on the loans they have made. Strains also have been evident at other intermediaries, and many securities have been downgraded by the rating agencies, suggesting that even those borrowers not relying on banks in many cases have faced higher costs and more restrictive terms

In responding to evidence of economic weakness, to a lessening of inflation pressures, and to slow monetary growth, the Federal Reserve has used all three of its key policy tools. More accommodative reserve provision through open market operations, together with two cuts in the discount rate totaling a full percentage point, have brought the federal funds rate down to around 6-1/4 percent. This important short-term rate has fallen 2 percentage points since mid-1990 and roughly 3-1/2 percentage points over the past two years. We also reduced the remaining reserve requirement on nonpersonal time and similar accounts from 3 percent to zero. The requirement to hold non-earning reserves at the Federal Reserve in effect imposes a tax on credit intermediation at banks and thrifts. This action lowered this tax and was aimed specifically at relieving the tightening of credit availability at depository institutions.

Other short-term market interest rates generally have fallen nearly as much as the federal funds rate since mid-1990. Long-term interest rates also have retreated, and rates on fixed-rate mortgages are now in the vicinity of their lows of the past decade. Lower interest rates and oil prices have helped to lift some major stock price indexes to all-time highs. After firming in December and early January

on safe-haven demands, the exchange value of the dollar has shown unelcome weakening tendencies at times recently

The Behavior of Money and Credit in 1990 and Early 1991

As I indicated earlier, sluggish expansion of the monetary aggregates was an important ingredient in the decisions to ease policy during recent months. The broader aggregates ended 1990 well down in the lower halves of their annual growth ranges. The Federal Open Market Committee recognized that the relationship between M2 and spending is uncertain, but the slower growth of M2 in the latter part of 1990 and early 1991 brought the aggregate so far below our expectations that it seemed highly likely to be inconsistent with the Committee's longer-run objectives for the economy.

The weakness in M2 is a complex development and requires careful interpretation. The shortfall from our expectations appeared to be related to the stalling of nominal income in the fourth quarter, and also to the circumstances surrounding the extraordinary decline in assets at depository institutions last year, which in turn had implications for future as well as current spending. As their willingness or capacity to expand their assets diminished, banks and thrifts became less eager to attract deposits of all kinds. Hence, they paid unusually low rates on retail deposits in M2 relative to market interest rates. Moreover, public attitudes toward deposits also seemed to have been adversely affected by developments in the depository sector, publicity about thrift closings, Bank Insurance Fund losses, and credit quality



problems at commercial banks evidently encouraged shifts of funds into Treasury securities or alternative nondeposit instruments

The shifting of credit intermediation away from depositories appeared likely to be having a damping effect on the spending of those borrowers without ready access to alternative sources of funds at comparable interest rates. Thus, part of the slow growth in retail deposits could be seen as symptomatic of developments in the credit granting process with adverse implications for contemporaneous and future aggregate demand.

However, a portion of the credit flows no longer being intermediated by depositories has been readily replaced by alternative suppliers. In particular, markets for securities backed by mortgages and consumer loans have allowed demands for these types of credit to be met with little or no increase in costs to the ultimate borrowers. And some businesses with relatively high credit ratings have had little difficulty switching from banks to commercial paper markets and other sources of short-term funding. The reduction in funding through retail deposits associated with this type of shift in credit flows would not signal a weakness in current or future spending. Some of the surprising weakness in M2 growth has been reflected simply in a higher velocity than otherwise, rather than having been indicative of restraint on spending. M2 velocity last year did not exhibit the decline that would be expected with the drop in short-term market interest rates in late 1989 and 1990.

But with not all of the weakness in M2 likely to be offset by a lasting shift in velocity, the behavior of this aggregate seemed

increasingly to signal a weaker path for the economy than consistent with the Committee's intentions. Our policy easings over recent months were keyed partly to reinvigorating growth of M2 to a rate more likely to be consistent with satisfactory economic performance. If history is any guide, the policy-induced declines in interest rates on market instruments relative to returns on M2 balances will generate the desired speed-up in M2 growth; indeed, we have begun to see some evidence of that in recent weeks, though it is still too early to be very confident that a new, more robust growth trend has been established.

Restrained growth of M3 last year was expected once the size of the runoff of thrift assets and of RTC activities became clear. But its increase was further depressed by a larger-than-expected decline in bank credit growth. The fall-off in total depository assets had an especially pronounced effect on M3 because this aggregate includes, in addition to retail deposits, certain managed liabilities whose issuance is more sensitive to overall depository funding needs. In fact, currency and money market mutual funds more than accounted for the expansion in this aggregate over 1990. M3 growth has picked up this year, but so far it has reflected the substitution by some depositories of large time deposits for non-M3 funding sources rather than a renewed expansion of their credit.

Although credit outstanding at depositories contracted last year, credit flows at other intermediaries and in the open market were better maintained. Some borrowers undoubtedly felt the effects of

tightening lending terms, but nonetheless the debt of domestic, non-federal sectors rose 5-3/4 percent last year. This growth rate, though considerably lower than in recent years, was well in excess of the percentage increase in nominal income. Growth of federal debt by contrast surged to 11 percent, of which more than 2 percentage points represented federal funding of Resolution Trust Corporation activities. Buoyed by federal government borrowing, the total debt of domestic nonfinancial sectors grew 7 percent, the midpoint of the FOMC's monitoring range for the aggregate.

Economic Prospects in 1991 and Monetary Policy Plans and Objectives

These economic, financial, and monetary conditions form the starting point for the Federal Reserve's view of economic prospects and plans for monetary policy in 1991. An important aspect of the outlook is the unusually high degree of uncertainty about how these conditions will evolve, in the face of the Gulf war and financial strains. Another is the recognition that there may be substantial lags between changes in financial conditions--notably, the decline in interest rates and the depreciation of the dollar in recent months--and the response of spending. The assessment of the FOMC, as captured by the central tendency of the individual projections of Board members and Reserve Bank presidents, is that the odds favor a moderate upturn in activity in coming quarters. Real GNP for the year as a whole is anticipated to grow in the area of 3/4 to 1-1/2 percent. Unemployment is likely to rise further before the recovery takes hold, and consequently the expectation is that the jobless rate will be somewhere between 6-1/2 and 7 percent at year-end.

The lower oil prices, if they persist, will help damp overall inflation, as will slack in labor and capital resources. Most of us believe that consumer prices will rise 3-1/4 to 4 percent this year--the best performance in several years.

The forces currently at work in restraining spending can be readily identified. Consumer and business confidence still looks to be quite depressed, evidently because of the high degree of uncertainty, as well as the weak economy. Moreover, problems in many parts of the real estate sector are not going to be resolved soon. In particular, the large stock of vacant commercial properties is virtually certain to limit activity in that sector for some time. It also will take a while to correct the associated financial difficulties facing many lenders, who are likely to remain quite conservative in making new loans. Finally, secondary effects on aggregate demand of the recent decline in our economy's output and real income are now in process of running their course.

Fortunately, several stimulative forces are in motion that enhance the chances of economic recovery. Monetary policy easings have brought about a significant drop in short-term interest rates. The decline started more than a year before the business cycle peak, a pattern unique in post-war experience and one which should help cushion the current recession. Moreover, short-term rates have declined substantially further in recent months. Long-term interest rates also have come down appreciably, reduced mortgage rates already have improved the affordability of housing, and thus should help to revive housing sales.

and starts    The enhanced international competitiveness of our industries augers well for the net export component of GNP. Furthermore, the fall in oil prices, which was especially marked in mid-January, has restored considerable domestic purchasing power. With most businesses having kept their inventories lean, the anticipated pickup in aggregate demand should show through relatively quickly in rising production.

The 1991 ranges for money and debt growth were selected by the Federal Open Market Committee to promote sustainable economic recovery, consistent with progress over time toward price stability. In keeping with a long-term disinflationary path, the FOMC ratified the provisional ranges set last July, which embody a 1/2 percentage point reduction in the M2 range compared with the limits for 1990. The midpoint of the 2-1/2 to 6-1/2 percent range for M2 growth matches the midpoint of the central tendency of the projections by the governors and presidents for nominal GNP growth. The recent sizable declines in short-term market rates normally would be expected to elevate the growth of M2 relative to that of nominal GNP. However, the FOMC anticipates that, as an offset, the ongoing restructuring of the thrift industry, combined with continued hesitancy of many banks to expand their assets, will again create an environment that restrains M2 growth relative to nominal GNP expansion and buoys M2 velocity. An outcome this year involving little change in M2 velocity would be quite similar to last year's experience.

The 1 to 5 percent range for M3 growth this year is the same as the sharply reduced range for last year. It again is lower than the

bounds for M2 growth because M3 is likely to continue to be more depressed than M2 by restructuring of the thrift industry and restrained growth in bank credit. The annual monitoring range for debt, however, has been reduced 1/2 percentage point relative to last year's specification, to 4-1/2 to 8-1/2 percent, in line with the sustained deceleration of this aggregate in recent years

#### Risks to the Economic Outlook

These money and debt ranges are wide enough to afford scope for policy reactions should the economy or its relationship to these financial aggregates diverge from FOMC expectations. Indeed, the individual forecasts of Board members and Reserve Bank presidents for the economy cover a relatively wide range. This divergence of opinion has its roots in the major uncertainties facing all forecasters today. Economic forecasters typically have had great difficulty in projecting business-cycle turning points, that is, judging when the relative strength of contending economic forces of contraction versus expansion will reverse. Moreover, the current outlook is unusually clouded, in part by uncertainties about the war and its effects. The Federal Reserve will need to remain alert to possible contingencies and will have to continue to respond flexibly to information about evolving trends.

Monetary policy thus will depend on how trends in economic activity and inflation actually unfold. Downside risks in the economic outlook are obviously there and not difficult to identify. For example, an extended war with Iraq clearly could carry some risk of further

undercutting public confidence and spending. Additional restraint on credit availability at depositories or increased public concern about the health of the banking system would be negative factors as well, and could show up initially as continued subpar money growth.

The worry has been expressed that, under current conditions of restrained willingness of depository institutions to extend credit, monetary policy easing moves may have only a minimal impact on lending and hence on overall spending. I believe this risk is exaggerated. Our easings and reserve requirement action have lowered bank funding costs appreciably. Some of this decline has been passed through to borrowers in the form of a lower prime rate, even with this reduction, funding costs have fallen relative to loan rates, and with higher profit potential banks should be more inclined to extend credit. Moreover, monetary policy stimulus works through other channels as well. Some potential borrowers will be encouraged by lower market interest rates to undertake additional expenditures financed, either directly or indirectly, by issuance of securities. Spending effects also can appear through routes involving price responses in equity and foreign exchange markets. Finally, the anticipated economic recovery itself will help allay problems of credit availability at, and public trust in, depository institutions. Indeed, there is some possibility that once the economy turns around, the expansion could become fairly robust, sparked by a return of consumer and business confidence and fueled by increasing availability of credit.

### Regulatory Initiatives

Monetary policy will continue to be conducted to foster attainment of important macroeconomic objectives. In so doing, we will need to remain mindful of any impediments to the process of credit intermediation. But monetary policy cannot resolve market imperfections in which credit for some financially sound projects is more expensive or less available than might otherwise seem warranted. Structural problems involving imperfections in credit and capital markets require structural solutions. To the extent that current banking regulations are impeding the efficient functioning of these markets, a more promising approach would lie along the path of revising those regulations. I would like to offer several thoughts along these lines, some of which are in only the formative stages.

We already have taken the step, as noted, of reducing reserve requirements on nontransaction accounts at banks and thrifts so as to eliminate the reserve tax on lending financed through these sources. This action lowered non-interest bearing required reserve balances at Federal Reserve Banks by some \$11-1/2 billion. The Federal Reserve Board also has the authority to reduce the required reserve ratio on transaction deposits from its current 12 percent to as low as 8 percent. However, unusual volatility in the federal funds rate appeared in January and early February, as required reserve balances moved to a seasonal low point. This experience suggests that reserve balances had fallen so far that many depository institutions were encountering difficulties in managing their reserve balances to meet day-to-day clearing



needs. Subsequently, volatility in the federal funds rate has diminished, as required reserve balances have begun to move above their seasonal lows, and as institutions have enlarged their clearing balances. These developments should continue for a time. Even so, the experience early this year suggests caution in considering further reductions in required reserve ratios, at least for a while. We shall, however, continue to assess this situation.

The recent episode of more volatile funds trading also has underscored the increased reluctance depositories have exhibited in recent years in availing themselves of short-term adjustment credit at the discount window. The reluctance has stemmed from fears of being identified as having more fundamental funding problems. Because of depository reluctance, the discount window in recent years has been a less effective safety valve in relieving transitory pressures in the reserves and funds markets. Tapping the window for adjustment credit, when alternative sources of funds temporarily are not available on reasonable terms from usual sources, is not indicative of longer-term stresses at borrowing institutions. Despite bank reluctance, borrowing has been somewhat higher on occasion this year as banks were in the process of adapting to the lower reserve requirements. We would not be surprised to see somewhat higher adjustment borrowing persist. The Federal Reserve has no desire to circumscribe the legitimate use of the discount window, and market participants should not interpret such use as indicating underlying problems for the institutions involved.

Another regulatory area in which possible steps are being considered pertains to the guidelines used in the supervisory process. The Federal Reserve is working with the other bank supervisory and regulatory agencies to ensure that bank examination standards are prudent and fair and do not artificially encourage or discourage credit extension. The intent of these efforts is to contribute to a climate in which banks make loans to creditworthy borrowers and work constructively with borrowers experiencing financial difficulties, consistent with safe and sound banking practices. For example, the agencies are studying steps to clarify that the supervisory evaluation of real estate collateral is to be based, not solely upon liquidation prices, but upon the ability of a property to generate cash flow, given reasonable projections of rents, expenses, and rates of occupancy over time. We need a balanced evaluation process that endeavors to reflect the long-term value of an illiquid asset, rather than the exaggerated appraisals that have been evident in both the upside and the downside of the real estate cycle in recent years.

The supervisory agencies also are seeking to encourage banking institutions to provide additional public disclosure on their nonperforming assets. Under present circumstances, as best we can judge, the market tends to suspect the worst. Additional disclosure would supplement data on the level of nonperforming loans with information on the amount of such loans that are in fact generating substantial cash income. Other similar steps are under consideration.

In general, we have emphasized our view that prudent lending standards and effective and timely supervision should not inhibit banking organizations from playing an active role in financing the needs of sound, creditworthy borrowers. Such an approach can contribute to the efficient functioning of credit markets and thereby complement monetary policy in promoting the attainment of the nation's overall economic objectives