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Statement by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

of the

United States Senate

January 29, 1992

Mr. Chairman members of the committee, I want to thank you for scheduling this hearing to consider my nomination to a second term as Chairman of the Federal Reserve Board and to a full 14-year term as a member of that Board. I am especially grateful to President Bush for the confidence he had in me to make these nominations.

I have testified before you frequently on the state of the economy and the conduct of monetary policy, including as recently as two weeks ago. I also have given you my views and those of the Federal Reserve Board on a wide range of specific regulatory and supervisory matters pertaining to banks over the last several years. I would expect to be addressing your questions on these issues again here today. In my brief opening statement, however, on the occasion of these hearings on my confirmation, I thought it might be appropriate to step back a little from the application of policy in specific circumstances and discuss some general principles that I believe should guide decisions on the monetary policy and banking structure of this country.

I see the fundamental task of monetary policy as fostering the financial conditions most conducive to the American economy performing at its fullest potential. As I have often noted before, there is every reason to believe that the main contribution the central bank can make to the

achievement of this national economic objective over long periods is to promote reasonable price stability. Removing uncertainty about future price levels and eliminating the costs and distortions inevitably involved in coping with inflation will encourage productive investment and saving to raise living standards. Monetary policy is uniquely qualified to address this issue: Inflation is ultimately determined by the provision of liquidity to the economy by the central bank; and, except through its effect on inflation, monetary policy has little long-term influence on the growth of capital and the labor force or the increase in productivity, which together determine long-run economic growth.

But a central bank must also recognize that the "long run" is made up of a series of "short runs". Our policies do affect output and employment in the short- and intermediate-terms, and we must be mindful of these effects. The monetary authority can, and should, lean against prevailing trends not only when inflation threatens, but also when the forces of disinflation seem to be gathering excessive momentum. That is, in fact, what has concerned us in recent months, and we have been taking actions designed to assist in returning the economy to a solid growth path.

However, the Federal Reserve, or any other central bank, must also be conscious of the limits of its capabili-

ties. We can try to provide a backdrop for stable, sustainable growth, but we can not iron out every fluctuation, and attempts to do so could be counterproductive. What we have learned about monetary policy since the beginnings of the Federal Reserve System is that the longer-term effect of a policy action may be quite different from its initial impact; what we don't know with precision is the size and timing of these effects, especially in the short run. Uncertainty about the near-term twists and turns of the economy along with the awareness of the potential differences between long- and short-term effects suggest both flexibility in the conduct of monetary policy and close attention to the longer-term context in conducting day-to-day operations.

Monetary policy actions are transmitted to the economy through the financial system, and the influence of weakness in that system on how the economy responds has been all too evident in recent years. A structurally sound and vigorous financial system not only facilitates monetary policy implementation, but is itself no less important to support an economy operating at its highest potential. Such a system must effectively and efficiently gather savings and distribute them to where they will be of most value to society in promoting productive investment and supporting consumption. Banks and other depositories have a key role

to play in this system. They are the channels through which payments pass, they are the chief repositories of households' liquid savings, and they extend credit to many who have limited, if any, access to alternative sources of financing. Our nation's banking system must be strong--not only in the sense of safe and sound, but also in the sense of being efficient and innovative in delivering vital services to the economy. That strength undoubtedly has eroded in recent years, in part through errors of judgment by depositories and their regulators, but also through the combined effects of a stiffer competitive environment and continued legal restraints on the ability of depositories to respond and adapt.

Against that background I, and the Board of Governors, have brought three interrelated principles to bear on our approach to banking structure and regulation. First is the importance of a strong capital position. Capital brings market discipline to bear on institutions that otherwise might be tempted to take excessive risk by their access to the federal safety net. And, it insulates the taxpayers holding up that safety net from the losses associated with unwise risk taking, should that occur nonetheless. Second is the need for more certain and prompt supervisory actions when capital and other key indicators of the financial

health of an institution decline. This not only will protect the taxpayers, but it also gives depositories planning their financial structures more certainty about governmental reactions, and induces them to take early action to strengthen those structures.

Congress and the regulators have gone a long way in acting on these first two principles. Unfortunately, progress on the third is more limited. That principle embraces the necessity for greater competitive scope for well-capitalized banking organizations--across boundaries of geography and product line. Both sets of boundaries have been made increasingly arbitrary and artificial by innovation and internationalization of financial services. An ability to deliver desirable services to the public is a prerequisite for generating the profits necessary to build capital and for keeping an innovative banking system capable of meeting the changing needs for credit and deposit services of a dynamic economy.

The last four years have seen no paucity of challenges at the Federal Reserve. As much as we sometimes might wish otherwise, I suspect the years ahead will be no less challenging. While much remains to be done, important strides have been made--in private markets and in government policies to restore the normal vigor of the American economy and our banking system. To that end, I believe the Banking

Committees' oversight and our continuing consultations have been a most helpful and constructive factor. Should the Senate choose to confirm me for a second term as Chairman of the Federal Reserve Board, I would look forward to working with this Committee to assure the sound financial system and vital economy the American people rightfully expect.