For use at 9 45 a m EDT
Tuesday
July 21, 1992

Testimony by

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

July 21, 1992

Mr Chairman and members of the Committee, I am pleased to have this opportunity to present the Board's semiannual report on monetary policy to the Congress Earlier this month, when the Federal Open Market Committee formulated its plans and objectives for the next year and a half, it did so against the backdrop of an economy still working its way through serious structural imbalances that have inhibited the pace of economic expansion In light of the resulting sluggishness in the economy and of persistent weakness in credit and money, the System on July 2 cut the discount rate by 1/2 percentage point, and eased reserve market conditions commensurately These actions followed a reduction in the federal funds rate in early April The recent easings of reserve conditions should help to shore up the economy, and coming in the context of a solid trend toward lower inflation, have contributed to laying a foundation for a sustained expansion of the U S economy

The U.S. economy and monetary policy

Our recent policy moves were just the latest in a series of twenty-three separate easing steps, beginning more than three years ago In total, short-term market interest rates have been reduced by two-thirds The federal funds rate, for example, has declined from almost 10 percent in mid-1989 to 3-1/4 percent currently The discount rate has been cut to 3 percent--a twenty-nine year low Despite the cumulative size of these steps, the economic recovery to date nonetheless has been very hesitant Based on experience over the past three or four decades, most forecasters would have predicted that a reduction of the magnitude seen in short-term interest rates,

nominal and real, during the past three years would by now have been associated with a far more robust economic expansion

Clearly the structural imbalances in the economy have proven more severe and more enduring than many had previously thought The economy still is recuperating from past excesses involving a generalized overreliance on debt to finance asset accumulation Many of these activities were based largely on inflated expectations of future asset prices and income growth In short, an overbuilding and overbuying of certain capital and consumer goods was made possible by overleverage And, when realities inevitably fell short of expectations, businesses and individuals left with debt-burdened balance sheets diverted cash flows to debt repayment at the expense of spending, while lenders turned considerably more cautious

This phenomenon is not unique to the United States To a greater or lesser extent, similar adjustments have gripped Japan, Canada, Australia, the United Kingdom, and a number of northern European countries For the first time in a half century or more, several industrial countries have been confronted at roughly the same time with asset-price deflation and the inevitable consequences Despite widespread problems, we seem to have at least avoided the crises that historically have been associated with such periods in the past

In the United States especially, important economic dynamics ensued as the speculative acquisition of physical assets financed by debt outpaced fundamental demands In some markets for physical assets, such as office buildings, a severe oversupply emerged, and prices plummeted In others, such as residential housing, average price appreciation unexpectedly came to a virtual standstill, and

prices fell substantially in some regions Firms that had been subject to leveraged buyouts based on overly optimistic assumptions about the future values at which assets could be sold began to encounter debt servicing problems

More generally, disappointing earnings and downward adjustment in the values of assets brought about reduced net worth positions and worsened debt-repayment burdens Creditors naturally pulled back from making risky loans and investments, and as pressures mounted on lenders' earnings and capital, some features of a "credit crunch" appeared With borrowers themselves becoming more cautious about taking on more debt, as well as about spending, credit flows to nonfederal sectors diminished appreciably

It is not that this process was unforeseeable in the latter years of the 1980s The sharp increase in debt and the unprecedented liquidation of corporate equity clearly were unsustainable and would eventually require a period of adjustment What was unclear was the point at which financial problems would begin to constrain spending and how strong those constraints would be Forecasts of difficulties with debt and strained balance sheets had surfaced from time to time over the past decade But only in recent years did it become apparent that debt leverage had reached its limits, inducing consumers and businesses to retrench Moreover, the degree of retrenchment has turned out to be much greater than experience since World War II would have suggested

The successive monetary easings have served to counter these contractionary forces, fending off the classic "bust" phase that seemed invariably to follow speculative booms in pre-World War II economic history During those severe episodes, sharp declines in

output and income were associated with a freezing up of credit availability, widespread bankruptcies by borrowers, and closings of newly insolvent financial institutions Thus, balance sheets were cleansed only through the massive writing off of loans, involving a widespread destruction of creditor capital

To be sure, elements of this historical process have been at work in recent years, but the monetary policy stimulus since mid-1989 has forestalled such a severe breakdown Lower interest rates have lessened repayment burdens through the refinancing and repricing of outstanding debt, and together with higher stock prices have facilitated the restructuring of balance sheets Indeed, considerable progress in this regard has become evident for both households and businesses The much more subdued rate of household and business credit expansion has reduced the leverage of both sectors Household debt service payments as a percent of disposable personal income have retraced around one-half of the runup that occurred during the previous expansion, and further progress appears in train Similarly, nonfinancial corporations' gross interest payments as a percent of cash flow are estimated to have retraced much of the roughly 10 percentage point increase that occurred in the expansion The improvements in balance sheets, together with the beneficial effects of lower interest rates, have been reflected in reduced delinquencies on consumer loans and home mortgages, increased upgradings of firms' debt ratings, and narrowed quality spreads on corporate securities Furthermore, lower interest rates, along with two reductions in reserve requirements, have appreciably cut the funding costs of depository lenders, materially improved interest margins, and fostered the replenishment of depository institution capital

Although greatly moderating the potential adverse effects of the necessary adjustment process on economic activity, monetary stimulus also has stretched out the period over which adjustments will occur A more drawn out adjustment of impaired balance sheets, as we now are experiencing, obviously is much preferable to the alternative an adjustment through massive financial and economic contraction Yet the ongoing corrective process has meant that the economic expansion has been hobbled in part by the continued restraint on spending by still overleveraged and hence cautious debtors Balance sheets ultimately will reach comfortable configurations, but even before then we should experience a quickening pace of economic activity as the grip of debt burden pressures begins to relax Last year I characterized this process as the economy struggling against a 50-mile-an-hour headwind Today its speed is decidedly less, but still appreciable

Uncertainty about how far the process of balance-sheet adjustment would have to go and for how long the spending retrenchment of overleveraged debtors would continue has been a factor in shaping Federal Reserve policy over the past few years This uncertainty has been shared by many other observers, who, based on past experience, were somewhat skeptical about the strength and persistence of spending restraint by both the private and public sectors, and dubious about the persistence of disinflationary forces Against that background, more rapid or forceful easing actions more than likely would have been interpreted by market participants as risking a resurgence of inflation That would have led to higher rather than lower long-term interest rates As I have indicated many times before this Committee, lower long-term rates are crucial in promoting progress toward more

stable balance sheet structures in support of sustained economic expansion

In fact, long-term interest rates have stayed disturbingly high in the face of sharply lower short-term rates A greater decline in long rates would have encouraged additional restructuring of business and household balance sheets and fostered stronger spending on business fixed investment goods, housing, and consumer durables Bond yields have not come down more primarily because investors have been inordinately worried about future inflation risks While they seem to exhibit only modest concern over a reemergence of stronger inflation during the next few years, investors apparently fear a resurgence further in the future, to a large extent as a consequence of expected outsized budget deficits exerting pressure for monetary accommodation

Other forces have added to the restraint on the economy associated with balance sheet adjustments The scaling back of defense spending has been retarding near-term economic growth A significant reallocation of resources is an inevitable consequence of the phase-down of defense spending, involving the redeployment of military personnel as well as industrial and technological capacity into civilian activities Such shifting of resources away from military production promises a welcome boost to long-run prospects for the nation's productivity and growth Nonetheless, the process of transition involves significant frictions and lags, and in the meantime the falloff of the military budget has represented a drag on aggregate demand At the same time, budgetary problems among states and localities have forced painful cutbacks by those units and burdensome tax increases as well

In addition, the noticeable slowdown in economic growth in other major industrial countries since mid-1990 has further tended to depress demand for goods and services produced in the United States Fortunately, continued rapid economic growth on the part of developing countries, whose imports from the United States have grown in relative importance, has prevented a greater weakening in the expansion of our exports

The U.S. economic outlook

Clearly in this environment, with conflicting forces of expansion and contraction continuing to vie for supremacy, any projection must be viewed as tenuous In this context, the central tendencies of the projections of Federal Reserve Board members and Reserve Bank presidents are given in the Board's report They project that the economic expansion is likely to strengthen moderately, to a range of 2-3/4 to 3 percent over 1993. Such a pace is expected to reduce the unemployment rate noticeably over the next year and a half This outlook is supported by several considerations, including the stimulus now in train from recent interest rate declines and the progress being made by borrowers and lenders in repairing strained balance sheets Some pent-up demand for business capital goods, housing, and consumer durables should surface as the incentives for spending retrenchment abate

In our judgment, the interest rate declines to date, working to offset spending constraints related to balance-sheet strains, should not endanger the further ebbing of inflationary pressures Even as the anticipated strengthening of economic activity occurs, monetary policy will continue to promote ongoing progress toward the longer-run objective of price stability, which should lay the

foundation for sustained economic expansion The financial fundamentals, such as money and credit growth, point to a continuation of disinflationary trends, and the central tendency of our projections for CPI inflation next year is 2-3/4 to 3-1/4 percent Were this to be realized, inflation would be about back to a pace last seen on a sustained basis around a quarter century ago As I often have noted to this Committee, the most important contribution the Federal Reserve can make to encouraging the highest sustainable growth the U S economy can deliver over time is to provide a backdrop of reasonably stable prices on average for business and household decision-making

Recent behavior of the monetary aggregates

The relationship between money and spending also has been profoundly affected by the process of balance sheet restructuring The broad monetary aggregates, M2 and M3, currently stand below their annual growth ranges, despite the earlier substantial declines in short-term interest rates My previous testimonies to the Congress noted that aberrant monetary behavior emerged in 1990 and has since intensified. We at the Federal Reserve have expended a great deal of effort in studying this phenomenon, and have made some progress in understanding it To summarize our findings to date The weakness of the broad monetary aggregates appears importantly to have reflected the variety of pressures that rechannelled credit flows away from depository institutions, lessening their need to issue monetary liabilities The public, in the process of restructuring and deleveraging balance sheets, found that monetary assets had become less attractive relative to certain nonmonetary financial assets or to debt repayment

The reduced depository intermediation stemmed from emerging problems of asset quality, which in turn prompted both the pulling back of depositories from lending and responses by regulators that reinforced those tendencies One such response was the shutting down or sale of insolvent thrift institutions In the process, some $90 billion of thrift assets have been taken onto the books of the Resolution Trust Corporation, where they are funded by government securities instead of depository liabilities The managed liabilities of depositories have been most affected by this shift. However, retail depositors also have been induced to shift into other instruments by the abrogation of their original contracts by acquiring institutions and the consequent disruption of their banking relationships

At banks and solvent thrifts as well, problems of asset quality, especially for commercial real estate, were mounting as the 1980s came to a close Banks reacted by tightening their nonprice lending terms and credit standards appreciably and widening the spread of lending rates relative to costs of funds Upward pressure on bank loan rates was augmented as investors, concerned about adequate bank capitalization, raised risk premiums on bank debt and short-term managed liabilities In addition, regulatory initiatives, such as stricter capital standards, higher insurance premiums, and more intense supervisory scrutiny, raised the cost of depository intermediation Reserve requirement cuts have represented only a partial offset. As intermediation costs rose, banks further increased loan spreads and redoubled efforts to securitize loans and otherwise constrain expansion in their balance sheets

More recently, the decline in short-term market rates, combined with the improvement in asset quality that was partly associated with the modest economic expansion, has considerably boosted bank earnings Banks also have strengthened their financial condition by improving their liquidity position and by taking steps that should reduce noninterest expenses over the long run through restructuring and, in some cases, consolidation A number of banks--especially large banks--have conserved capital by reducing dividends Banks have regained access to capital markets and have significantly rebuilt their capital positions Intermediation costs and pressures to bolster capital, however, have been further elevated by the added restrictions contained in the FDIC Improvement Act Partly as a consequence, lending spreads have stayed relatively high, as suggested by a prime rate that is a substantial 2-3/4 percentage points above the federal funds rate Recent survey responses suggest that nonprice terms and lending standards, though not tightening further, also have remained stringent

Bank lending has shown few signs of strengthening, as demands for bank loans have stayed dormant. The internal cash flows of nonfinancial businesses have strengthened, and many firms have raised substantial funds in equity markets, so overall credit demands have been light Large firms, especially those with good credit ratings, have preferred bond markets over banks as a place to borrow Meanwhile, households, feeling the strain of debt service burdens, have rechannelled cash flows away from retail deposits to the repayment of consumer debt at banks and other lenders They were also encouraged to deleverage their balance sheets by the wider spread between consumer loan rates and retail deposit rates, which was

accentuated on an after-tax basis by the phase-out of the tax-deductibility of interest payments on consumer loans

With little need for new funding, banks and thrifts have lowered rates on retail time deposits, especially on intermediate- and long-term accounts, by more than market rates have declined Under regulatory pressure, banks also have cut back reliance on, and returns to, brokered deposits. Even on NOW accounts, savings deposits, and money market deposit accounts, where inflows have strengthened, returns on the larger accounts--likely involving the most interest-sensitive depositors--have dropped much faster than have the most common rates paid The comparatively high returns on longer-term debt and equity instruments also have drawn household assets out of retail deposits Bond and stock mutual funds in particular have recorded substantial inflows

Thus, the weakness in the broader monetary aggregates, which has been even more pronounced this year, can be seen as an aspect of the entire process of rechannelling credit flows away from depositories and of restructuring the public's balance sheets However, the disintermediation and restructuring forces, which have acted powerfully to depress the growth of money, have exerted a less powerful constraint on spending, that is, slower money growth has not tended to show through percentage point for percentage point to reduced nominal GDP expansion Accordingly, these disintermediation and restructuring forces have tended to boost the velocity of the broader aggregates Increasing M3 velocity has been evident for some years, but the tendency for M2 velocity to rise was obscured until recent quarters by the opposing influence of declines in short-term market rates Lower short rates reduced the potential returns given

up by holding liquid M2 balances, thereby providing support to demands for M2 and countering the emerging tendency for its velocity to increase But M2 velocity appears to have registered an appreciable increase in the first half of this year, and the Federal Reserve has had to take the emerging behavior of velocity into account in deciding how much weight to place on slow M2 growth in guiding its policy actions

Prospective behavior of the monetary aggregates

Looking ahead, the recent increases in M2 velocity may well continue, although the uncertainties in this regard are considerable Returns on short-term market instruments relative to rates on M2 balances have dropped to unprecedented lows Depositories may well reduce liquid deposit rates further to restore longer-run relationships with money-market rates Should this occur, the resulting shifts in assets would reduce M2 demand without much influencing spending, further boosting the velocity of this aggregate The velocity of M2 also would tend to increase if any pickup in credit availability at banks associated with stronger economic expansion were funded out of their sizable holdings of liquid securities and newly issued managed liabilities rather than through recourse to retail deposits

Another significant imponderable involves the public's demand for M2 balances The extent to which households will continue to repay or avoid debt by drawing down M2 balances is difficult to foresee with any precision, as one cannot accurately gauge households' desired leverage positions An early completion of household balance-sheet adjustments would help to restore incentives to build liquid money balances, cutting into increases in M2 velocity Any decline in

long-term market rates could dissuade households from reaching for better returns out the yield curve beyond M2 maturities, and thereby bolster M2 demands even more than it would spending This would further offset the tendency for disintermediation and deleveraging to raise M2 velocity All told, predicting either the share of depository intermediation in overall credit flows or the share of money in the public's overall demand for financial assets is currently more difficult than usual

Against this background of considerable uncertainty about evolving monetary relationships, the Committee retained the current ranges for money and credit growth this year. These growth ranges are 2-1/2 to 6-1/2 percent for M2, 1 to 5 percent for M3, and 4-1/2 to 8-1/2 percent for debt On a provisional basis, the same ranges also were carried over to next year

If velocities were to show little further increase, then growth of the monetary aggregates within these specified ranges for both years would be consistent with the achievement of noninflationary economic expansion The reduction in short-term interest rates resulting from our recent policy action enhances the odds on money growing within these ranges On the other hand, if the unusual velocity increases seen so far this year were to persist over the next six quarters, then growth of M2 and M3 around or even below the lower bounds of their ranges could still be acceptable

In any case, the current ranges represent a way station on the road to reasonable price stability Even with a return to the traditional secular stability of M2 velocity, the midpoint of the current ranges would still be higher than needed to support long-run economic growth in the context of price stability And, if velocity

increases do in fact occur during a transition period to a higher long-run equilibrium level, then ranges somewhat lower than the current specifications would be warranted over this interval But in light of the considerable uncertainties about nearer-term velocity developments, the Federal Open Market Committee did not commit itself to new, respecified ranges for M2 or M3 for 1992 Such a respecification would carry the presumption that the new range was clearly more consistent with broader economic objectives, and in view of the uncertain relationships involved, the FOMC did not wish to convey that impression This year's ranges were carried forward on a provisional basis for 1993, until such time as additional experience and analysis could be brought to bear on the issue of monetary behavior In any event, the FOMC will revisit the issue of its money and credit ranges for 1993 no later than its meeting next February By then more evidence will have accumulated about evolving monetary relationships In light of the difficulties predicting velocity, signals conveyed by monetary data will have to continue to be interpreted together with other sources of information about economic developments

Concluding remarks

I expect that the economic expansion will soon gain momentum, which lower inflation should help to maintain Although the economy still is working its way through structural impediments to more vigorous activity, the advances that already have been made in this regard augur well for the future Banks and other lenders, having made considerable strides in rebuilding capital, have greater capacity to meet enlarged credit demands The strengthening of household finances to date has established a firmer foundation for future

consumer outlays And the restructuring of business balance sheets so far, together with improved labor productivity and profitability, has better positioned producers to support sustainable output gains These gains would be even larger if the federal government can make significant progress toward bringing the budget into balance, releasing saving for productive private investment, and brightening further the prospects for ongoing advances in living standards for all Americans