For release on delivery
10:00 a.m. E.D.T.
January 27, 1993

Statement by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

United States Congress

January 27, 1993

Mr. Chairman and members of the Committee, as you know, the Federal Reserve will submit its semiannual report on monetary policy to the Congress in just a few weeks, after our upcoming Federal Open Market Committee meeting. At that time, I will be in a position to address more specifically our expectations for economic growth and inflation, and the ranges of money and credit expansion that we anticipate to be consistent with the achievement of our goal of maintaining maximum sustainable growth in the economy, by fostering a stable, noninflationary, financial environment. Under the circumstances, my opening remarks this morning will focus primarily on identifying the major tendencies visible in our economy today.

The available data suggest that economic activity has been increasing at a firmer pace of late. After rising at only about a 1-1/2 percent annual rate, on average, over the first five quarters of the expansion, real gross domestic product increased at about a 3-1/2 percent rate in the third quarter of 1992. The advance estimate of the Bureau of Economic Analysis for fourth-quarter growth, which will be released tomorrow, is expected by many analysts to show a substantial gain as well. Meanwhile, industrial production posted a healthy advance over the final three months of 1992, with solid growth for a broad range of industries.

The recent news on the inflation front also has been quite favorable, as businesses have continued their efforts to contain production costs and boost efficiency. All told, the

increase in the consumer price index excluding food and energy--a measure that is widely used as a rough proxy for the underlying trend of inflation--was just 3.3 percent over the twelve-month period ending in December, a full percentage point less than during 1991.

Although a number of economic indicators are distinctly encouraging, this is not to say that we have clear sailing ahead. As I indicated when I appeared before this Committee last March, households and businesses have been struggling to redress structural imbalances unparalleled in the postwar period. The speculative bidding up of real estate and other asset prices over the course of the 1980s fostered an excessive accumulation of debt and assets. The subsequent weakening of asset prices in the early 1990s left the balance sheets of many households and businesses strained with debt overload. Banks and other intermediaries that had financed the buildup suffered losses that severely eroded capital. The pressures to work down debt, reinforced by understandably more conservative lending practices, slowed economic growth. Some time ago, I likened these pressures to head winds of 50 miles per hour.

Those head winds have now slackened somewhat. But they have not disappeared. The process of balance sheet adjustment, while becoming less of a restraint on the economy, will doubtless be with us for some time. In addition, we are coping with a sizable retrenchment in the area of national defense. And, although U.S. domestic demand appears to be improving, many of

our key trading partners are experiencing disappointing economic performance. This is acting as a drag on our exports and our output.

Much of the strength suggested by the incoming U.S. data has been in the consumer sector. The speed-up in consumption comes after a period of more conservative spending behavior, when many households seem to have focused on paying down debts and shoring up balance sheets, so badly pressured by the events of recent years. The relative strength of spending, thus, may reflect the improvement that has been achieved to date in the financial health of households. Debt-to-income ratios have fallen slightly, and debt servicing burdens have declined quite noticeably, in large part because of the reductions in interest rates. At the same time, the value of household financial assets has been buoyed by the rise in stock prices last year. Moreover, concerns about housing prices, which probably were a key reason that consumers were so distressed for much of the past few years, seem to have lessened.

The strengthening of the housing market also may be important in a more specific way. Sales of single-family homes have picked up and when existing homes are sold, the capital gains that usually have accumulated over time can be realized. The buyer of the home typically takes out a mortgage greater than that paid off by the seller. The difference largely reflects the realized capital gain of the seller who receives unencumbered cash, only part of which is apparently added to a down payment on

a subsequent home purchase. Such cash provides the seller with additional liquid funds to spend on consumer goods and services.

History suggests that this is just what has been happening. The marked rise in existing home sales in recent months has added to households' purchasing power by enabling them to realize capital gains at an increasing rate, helping to fuel the growth in consumer spending. Homeowners also have an opportunity to liquify capital gains when refinancing an existing mortgage, and refinancing surged in the latter part of 1992. Realized or liquified capital gains are not taken account of in computation of the official saving rate, whose recent decline therefore probably overstates the drop in the flow of saving as perceived by households. However, unless home sales, mortgage refinancing, and the associated equity extraction continue to rise, there is a limit to how much longer this factor can fuel the growth of consumer spending. The measured personal saving rate is at a relatively low level, and further outsized increases in consumption are not very likely in the absence of a sustained pickup in income growth.

Consequently, a significant consideration, in terms of the outlook for consumer demand, is the employment picture. The optimism revealed in the recent surveys of consumer attitudes may prove fleeting if overall labor market conditions remain subdued.

Indeed, despite signs of modest improvement in the past few months, since the recession trough in March 1991, employment has shown essentially no net change on the payroll basis, and only a modest increase in the household series.

Of course, the softness in employment in the current expansion is partly the counterpart of another development--namely, a dramatic improvement in productivity. Since the recession ended in early 1991, productivity has grown at an average annual rate of about 2-1/2 percent, a better than expected performance given the relatively slow pace of the economic recovery to date.

The corporate restructuring and downsizing efforts that have been associated with the recent productivity gains have in part been a response to the profit squeeze that emerged during the 1990-91 recession. They also have been spurred by increasing costs of health insurance and other fringe benefits, which have restrained hiring and encouraged a surge in the use of temporary workers. But restructuring also seems to have reflected an effort to capitalize on new opportunities for greater efficiency. Although we cannot be sure how or why these new opportunities have arisen, I suspect they are the product of the accelerating advances in computer software and applications. Past large accumulations of computer hardware did not seem to have the expected effects on productivity. But a new synergy of hardware and software applications may finally be showing through in a significant increase in labor productivity.

These far-reaching changes in the production processes in manufacturing, and in the means by which services are produced and distributed, have apparently yet to run their course, though one must assume that the pace of restructuring will surely slow. Accordingly, we may see less of a tapering off in productivity gains in coming quarters than past cyclical experience would suggest. That prospect is highly favorable in terms of the longer-run potential output of the economy and our international competitiveness, but it would also imply some continuing adjustments in the work force in the near term.

The push to acquire state-of-the-art technology has also been providing a discernible thrust to capital spending in recent quarters--and likely will continue doing so. Real outlays for office and computing equipment have soared, as firms continue the transition to the more powerful and cost-effective machines that are now available, and purchases of communications equipment continue to be boosted by, among other things, the shift to fiber-optic networks. Demand for other, more traditional types of equipment now appears to be growing as well. The improved pace of economic expansion has doubtless lifted sales expectations, and the marked increases in profits and cash flow over the past year are providing funds for new purchases.

Problems, however, remain in a number of areas, though with some lessening of concern. Chief among them are the ongoing difficulties in the credit area. Depressed demand is doubtless the major explanation for weak loan growth at banks and many

other intermediaries. However, increased regulation presumably has also played a role. Moreover, lenders, seeking to protect their capital positions, have been extremely cautious. Although they seem to have stopped tightening credit terms, a significant easing is not yet evident.

Commercial real estate has accounted for much of the asset quality problems at financial institutions. Until real estate values clearly stabilize, banks and other intermediaries are not apt to become substantially more eager lenders. The liquidity of real estate markets remains impaired, and lenders are uncertain about the value of collateral and the appropriate level of reserves against nonperforming loans. The risk that further reserving may be necessary has led banks to bolster book capital, widen lending margins, and approach new credits with caution. It is not necessary for real estate values to rise to reduce this risk, but lenders need to be more confident that prices will not continue to fall and that, if necessary, they can sell collateral expeditiously at reasonably predictable prices. While there are some initial signs that commercial real estate markets in some regions are finding a bottom, uncertainty remains high. Having accumulated substantial liquid assets and rebuilt capital, banks seem well positioned to meet increased loan demand, especially once collateral uncertainty diminishes. Endeavors by both the Resolution Trust Corporation and private parties to encourage the development of a secondary market in commercial mortgages will help liquify the market in commercial

real estate itself. However, should problems in commercial real estate persist, credit conditions for small and riskier business may ease only gradually for some time.

Soft property prices, engendered by high vacancy rates and sluggish demand for space, are likely to continue to restrain commercial construction spending in 1993, and the prospects for multifamily housing are not much better. In addition, budgetary pressures on state and local governments remain intense.

Meanwhile, we must continue to work through the sizable adjustment in military spending that has been under way since the late 1980s. From a longer-run perspective, the defense cutbacks carry the anticipation of substantial benefits for the U.S. economy. By freeing up resources that can then be devoted to improving the nation's stock of productive physical and human capital, they should ultimately lead to higher living standards. In the short run, of course, lower defense spending is a depressant on economic activity, and on jobs and incomes. For industries and regions that rely heavily on military spending, the dislocations may well be sizable. In industries that depend on defense expenditures for at least 50 percent of their output, employment has fallen more than 20 percent (300,000 jobs) since 1987. And, in California, where the share of civilian employment in defense-related jobs may be almost twice the national average, the unemployment rate has risen to about 10 percent, nearly 3 percentage points above the national average.

In addition, our export performance is being restrained by developments abroad. Countries that earlier had been growing at least moderately have shown clear signs of slower growth, or outright declines, in economic activity. In both Germany and Japan, real output fell for part of 1992, and growth for the year as a whole was substantially less than in 1991. Many of the other countries of continental Europe have recorded only weak growth. And in Canada and the United Kingdom, signs of recovery from prolonged recession have ranged between weak and elusive.

Foreign officials have reacted to these developments with measures intended to boost spending and to promote recovery. In Japan, official interest rates have been lowered nearly 3 percentage points since the start of 1991, and a supplementary budget of additional government spending has just been passed. In Germany, the choice of policy steps has been complicated by the special circumstances associated with the massive task of unifying the economies of eastern and western Germany. Monetary conditions have been eased somewhat, but continued rapid money growth and persistent inflation have made officials cautious. In the other European countries tied to Germany through the exchange rate commitments of the European Monetary System, scope for aggressive monetary easing has been limited. This has led some countries to relax that commitment, at least for a time, and to ease monetary policy.

I will, of course, be discussing Federal Reserve monetary policy in detail when I present the System's

Humphrey-Hawkins Report to the Congress next month. However, let me comment briefly on an issue that has arisen recently with regard to the ranges for monetary growth in 1993. The issue, as I indicated in my letter to Senator Sasser earlier this month (attached), is that an unusual portion of aggregate spending has continued to be financed by credit granted outside of banks and other depositories--evidently a side effect of the process of the balance sheet restructuring that I referred to earlier. Should the phenomenon persist in 1993, it implies that growth in M2 consistent with our broader economic objectives would be slower than indicated by normal historical relationships of money and spending--and that a technical adjustment to our monetary growth ranges might thus be in order. That assessment is wholly technical and should not be interpreted as indicative of any change in monetary policy *per se*. Partly in view of these developments, the Federal Reserve can not rely exclusively on money supply growth relative to its targets in formulating monetary policy. In any event, the Federal Open Market Committee will reexamine this issue, along with other, broader considerations, when it meets next week to set monetary policy goals for 1993.

Regardless of the specific ranges established for the growth of money and credit over the coming year, the objectives of monetary policy remain unchanged: We are seeking to foster financial conditions that will encourage maximum sustainable growth in the economy. As I, and my colleagues, have stressed, a

noninflationary environment is a precondition to such a goal. For the coming year we will continue playing a constructive role in supporting an extension of the recent more hopeful signs of solid growth, while endeavoring to avoid any excesses that might lead to a flare-up of inflationary pressures down the road. Such a course will help the economy emerge from the financial difficulties of recent years, maintain the progress toward price stability that has been achieved thus far, and thereby promote a sustainable economic expansion.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D C 20551

ALAN GREENSPAN
CHAIRMAN

January 8, 1993

The Honorable Jim Sasser
Chairman
Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I appreciate having your views on the Federal Reserve's M2 money supply target for 1993. I want to emphasize that the issues I was addressing in my letter to Chairman Gonzalez were wholly technical in nature. In discussing possible reductions in the ranges, I was not signalling any lessening in the Federal Reserve's commitment to fostering financial conditions most conducive to the sustained expansion of the U.S. economy with the highest possible levels of employment and output over time. Nor was I endeavoring to indicate any change in monetary policy *per se*.

My observations were directed solely at the statistical problems we are having with our money supply aggregate measures, and their ability to appropriately track developments in the economy. That relationship is best represented by M2 velocity (the rate of money turnover, or nominal GDP divided by M2). This ratio increased substantially in 1992, despite continued declines in market interest rates, which usually are associated with falling velocity (see chart). Through the first three quarters of 1992 nominal spending increased at around a 5 percent annual rate, while M2 rose at only a 1-1/2 percent rate. A further increase is indicated for the fourth quarter of 1992.

We believe that these extraordinary increases in velocity reflect changes in the way spending is being financed. In response to the stresses of recent years, lenders and borrowers have taken steps to strengthen their financial situations. In the process, they have emphasized rebuilding capital, paying down debt, and raising funds in longer-term debt and equity markets. A side effect of this restructuring is that spending has been financed to an unusual degree outside of banks and other depositories, whose liabilities constitute the bulk of the monetary aggregates. As a counterpart, induced by higher yields, savers have channelled funds directly to borrowers via investments in longer-term debt and equity. This means that M2

and M3 as ways of financing economic activity are being replaced in part by alternative financing vehicles without impairing the economy's growth potential. The statistical result is that M2 and M3 velocities have risen; another is that we are making significant progress toward more comfortable financial conditions, which will help to support economic expansion. Still, it is unlikely that this process has reached an end, and its continuing influence on the statistically measured velocities of M2 and M3 will have to be taken into account by the Federal Open Market Committee when it considers the 1993 ranges in February.

I will be circulating your letter to the other FOMC members so they will be fully aware of your views when they consider the ranges at their next meeting. I am enclosing a staff study of M2 velocity behavior, and would be pleased to have our staff brief you or your staff on the technical reasons for the ongoing statistical increases in M2 velocity. I hope you have found these comments useful.

Sincerely,

(signed) Alan Greenspan

Enclosures