Testimony by

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Mr. Chairman and members of the Committee, I appreciate this opportunity to discuss with you developments in the economy and the conduct of monetary policy. Nineteen ninety-two saw an improved performance of our economy The expansion firmed, and inflation moderated. Some of the structural impediments to growth seemed to diminish. In particular, the financial condition of households, firms, and financial institutions improved. In addition, confidence rebounded late in the year.

Nevertheless, the expansion seemed to exhibit little momentum through much of 1992, unemployment remained high, and money and credit growth was sluggish In response, the Federal Reserve took steps to increase the availability of bank reserves on several occasions These actions brought short-term interest rates to their lowest levels in thirty years Long-term interest rates also fell in 1992 and early 1993 as inflation expectations gradually moderated and optimism developed about a potential for genuine progress in reducing federal budget deficits

Mr Chairman, in the last few years our economy has been held back by a variety of structural factors that have not been typical of post-World War II business cycles--certainly not occurring all at once. These factors have included record debt burdens, overbuilding in commercial real estate, and a substantial cutback in defense spending In this we have not been alone Other major industrial countries also have been experiencing unusual impediments to growth, and by comparison the recent performance of the U S economy has been relatively good Our monetary policy actions have been directed at facilitating adjustments to these developments and have in the process improved our economy's prospects for long-run sustainable growth.

Significant hurdles, of course, still remain to be overcome in the short run Nonetheless, in the view of the vast majority of business analysts, prospects appear reasonable for continued economic expansion and further declines in the unemployment rate The tasks of the monetary and fiscal authorities alike will be not only to support this prospective growth but also to set policies to enhance the capacity of our economy to produce rising living standards over time Before discussing the outlook in more detail, I would like to reflect on how monetary policy has interacted with the forces that have shaped developments over recent years

Recent Economic Developments and Monetary Policy in Perspective

I have often noted before this Committee the distinctly different nature of the current business cycle A number of extraordinary factors contributed to the earlier weakening in the economy and have worked against a brisk and normal rebound from the recession

Balance sheet restructuring has been, perhaps, the most important of these factors In the 1980s, debt growth, hand in hand with rising asset prices, considerably exceeded that of income, and debt burdens rose to record levels Debt-financed construction in the commercial real estate market was an extreme manifestation of this development, but it was apparent as well in other sectors of the economy

That these imbalances developed should not be entirely surprising The economy grew continuously for nearly eight years--from late 1982 through mid-1990, the longest peacetime expansion on record In this unusual period of uninterrupted growth, unrealistic expectations of what the economy could deliver seem to have developed In addition, households and businesses apparently were skeptical that inflation would continue to decline and, based on their experience during the 1970s, may even have expected it to rebound As a consequence, many may have shaped their investment decisions importantly on expectations of inflation-induced appreciation of asset prices, rather than on more fundamental economic considerations. In the commercial real estate sector, assessments of profit potential formed during the first half of the 1980s simply went too far, leading to an unavoidable period of retrenchment

The difficulties faced by borrowers in servicing their debts as the expansion slowed and the levelling out or decline in asset prices prompted many to cut back expenditures and divert abnormal proportions of their cash flows to debt repayment. This in turn fed back into slower economic growth In addition, financial institutions were faced with impaired equity positions owing to sizable loan losses as well as more stringent supervision and regulation and demands by investors and regulators for better capital ratios. In response, they limited the availability of credit, with particular effects on smaller businesses Over the last year or so, however, considerable progress has been made in strengthening balance sheets in both the nonfinancial and financial sectors Moreover, by some measures the rate of deterioration of the commercial real-estate industry might be slowing and prices in this sector may soon begin to stabilize Such developments should contribute to the sustainability of the expansion in the period ahead

Intensive business restructuring has been another important characteristic of the evolving economic situation In an environment of weak demand and intense competition here and abroad, many firms have found it necessary to take aggressive measures to reduce costs These actions have included selling or closing down unprofitable units and reducing their workforce. The process of restructuring has been given added momentum by the availability of new computing and communication technologies. Although these changes involve difficult adjustments in the short run, they are producing important gains in productivity, which will boost real wages and living standards over time

The contraction in defense spending has been a third development restraining the expansion Real federal defense expenditures dropped about 6 percent in 1992, and are down 9 percent from their 1987 peak. Those regions of the country with substantial defense-related activity have been among the areas whose economies have performed especially poorly Although this development is having a contractionary influence on the economy in the short run, over a longer period the productive resources freed in this process will find employment in the private sector, contributing to capital formation and the growth potential of the economy

Another, less-discussed factor that contributed to the formulation of our recent monetary policy dates not from the 1980s but rather from the 1970s--inflation and inflation expectations Over the past decade or so, the importance of the interactions of monetary policy with these expectations has become increasingly apparent The effects of policy on the economy depend critically on how market participants react to actions taken by the Federal Reserve, as well as on expectations of our future actions These expectations--and thus the credibility of monetary policy--are influenced not only by the statements and behavior of the Federal Reserve, but by those of the Congress and the Administration as well

Through the first two decades of the post World War II period, this interaction was patently less important. Savers and investors, firms and households made economic and financial decisions based on an implicit assumption that inflation over the long run would remain low enough to be inconsequential There was a sense that our institutional structure and culture, unlike those of many other nations of the world, were alien to inflation As a consequence, inflation premiums embodied in long-term interest rates were low and effectively capped Inflation expectations were reasonably impervious to unexpected shifts in aggregate demand or supply. In those circumstances, monetary policy had far more room to maneuver, monetary policy, for example, could ease aggressively without igniting inflation expectations

Even during the rise in inflation of the late 1960s and 1970s there was a clear reluctance to believe that the inflation being experienced was other than transitory, it was presumed that inflation would eventually retreat to the 1 to 2 percent area that prevailed during the 1950s and the first half of the 1960s Consequently, long-term interest rates remained contained

But the dam eventually broke, and the huge losses suffered by bondholders during the 1970s and early 1980s sensitized them to the slightest sign, real or imagined, of rising inflation At the first indication of an inflationary policy--monetary or fiscal--investors dump bonds, driving up long-term interest rates To guard against unexpected losses, investors now demand a considerable premium in bond yields--a premium that seems out of proportion to the likely future path of inflation, but one that nevertheless conditions the environment of monetary policy today The steep slope of the yield curve and the expectations about future interest rates that it implies suggest that investors remain quite concerned about the possibility of higher inflation over the longer run, even as they appear less concerned about that possibility for the next year or two.

This heightened sensitivity affects the way monetary policy interacts with the economy. An overly expansionary monetary policy, or even its anticipation, is embedded fairly soon in higher inflation expectations and nominal bond yields Producers incorporate expected cost increases quickly into their own prices, and eventually any increase in output disappears as inflation rises and any initial decline in long-term nominal interest rates is more than retraced. To be sure, a stimulative monetary policy can prompt a short-run acceleration of economic activity But the experience of the 1970s provided convincing evidence that there is no lasting tradeoff between inflation and unemployment, in the long run, higher inflation buys no increase in employment

This view of the capabilities of monetary policy is entirely consistent with the Humphrey-Hawkins Act As you know, the Act requires the Federal Reserve to "maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The goal of moderate long-term interest rates is particularly relevant in the current circumstances, in which balance sheet constraints have been a major--if not the major--drag on the expansion. The halting, but substantial, declines in intermediate- and long-term interest rates that have occurred over the past few years have been the single most important factor encouraging balance-sheet restructuring by households and firms and fostering the very significant reductions in debt service burdens And monetary policy has played a crucial role in facilitating balance sheet adjustments--and thus enhancing the sustainability of the expansion--by easing in measured steps, gradually convincing investors that inflation was likely to remain subdued and fostering the decline in longer-term interest rates

That is the background against which we have conducted monetary policy for the last several years Through this period, Federal Reserve policy was directed at fostering sustainable growth in the economy Recognizing tendencies for the economy to slow, the Federal Reserve began to ease monetary policy in the spring of 1989 In response to the downturn that began in August 1990, we accelerated the reduction in short-term interest rates Last year, we extended our earlier reductions in interest rates by lowering the federal funds rate another percentage point through another cut in the discount rate and injections of a large volume of reserves In addition to reducing interest rates, the Federal Reserve lowered reserve requirements last year for the second time in eighteen months to help reduce depository institutions' costs and encourage lending

Although the easing actions over the past few years have been purposely gradual, cumulatively they have been quite large Short-term interest rates have been reduced since their 1989 peak by nearly 7 percentage points; looked at differently, short rates have been lowered by two-thirds Some have argued that monetary policy has been too cautious, that rates should have been lowered more sharply or in larger increments

In my view, these arguments miss the crucial features of our current experience. the sensitivity of inflation expectations and the necessity to work through structural imbalances in order establish a basis for sustained growth In these circumstances, monetary policy clearly has a role to play in helping the economy to grow, the process by which monetary policy can contribute, however, has been different in some respects than in past business cycles Lower intermediate- and long-term interest rates and inflation are essential to the structural adjustments in our economy, and monetary policy thus has given considerable weight to helping such rates move lower

Some have suggested that the decline in inflation permitted more aggressive moves and, had the downward trajectory of short-term interest rates been a bit steeper, that aggregate demand would have been appreciably stronger I question that as well. Basing this argument on the lower inflation that has occurred is a *non sequitur*, the disinflation very likely would not have occurred in the context of an appreciably more stimulative policy, and such a policy could have led to higher inflation in the next few years Moreover, such a policy would not have dealt fundamentally with the very real imbalances in our economy that needed to be resolved before sustainable growth could resume And it would have run the risk of aborting the process of balance sheet adjustment before it was completed The credibility of noninflationary policies would have been strained, and longer-term interest rates likely would be higher, inhibiting the restructuring of balance sheets and reducing the odds on sustainable growth.

Recent evidence suggests that our approach to monetary policy in recent years has been appropriate and productive Even by last July, when I presented our midyear report to the Congress, some straws in the wind suggested that the easing of monetary policy to that date and the various financial adjustments underway in the economy were proving successful in paving the way for better economic performance Households and businesses appeared to have made significant progress in shoring up their balance sheets; considerable reductions in debt servicing requirements had been achieved, equity had risen, and liquidity was higher. In the financial sector, bank profitability had improved, and a brisker flow of bank earnings as well as issuance of new equity shares and subordinated debt had bolstered capital ratios, helping to arrest the tightening of lending terms and standards The lower level of interest rates, both short- and long-term, helped to limit the decline in real estate values and boost the profitability of thrift institutions, as a byproduct reducing the losses that would have been borne by the Resolution Trust Corporation and, ultimately, the taxpayer

It is now apparent that our July expectation of a firmer trajectory of output has been borne out GDP growth is estimated to have picked up to a 3-1/2 percent rate during the second half of 1992, following a more modest increase in the first half Beginning in the late summer, some quickening in the pace of auto sales could be detected, and spending on other consumer durables strengthened as well Single-family housing starts rebounded Industrial orders, production, and shipments all rose. In association with this stronger trend, payroll employment growth has picked up and the unemployment rate has dropped back to 7 1 percent by early this year--certainly too high, but well below the level at mid-year For 1992 as a whole, real gross domestic product is currently estimated to have increased at about a 3 percent rate And indications are that the expansion is continuing in the early months of 1993, though perhaps at a slightly reduced rate

The news on inflation in 1992 likewise was quite encouraging The consumer price index rose just 3 percent in 1992, at the lower end of the central tendency of our July projections Excluding volatile food and energy prices, inflation last year was the lowest in two decades. Although the January CPI was surprisingly high, judging from survey evidence and the behavior of long-term interest rates, inflation expectations appear to be gradually diminishing, as market participants gain more confidence that inflation is being contained

Money and Credit in 1992

These favorable outcomes occurred despite slow growth of the money and credit aggregates. The Federal Open Market Committee had established ranges of 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 domestic nonfinancial sector debt Over the year, M2 actually rose 2 percent, M3 1/2 percent, and debt 4-1/2 percent Thus, both of the monetary aggregates finished the year about 1/2 percentage point below their ranges, and debt just at its lower bound

Interpreting this slow growth was one of the major challenges faced by the Federal Reserve last year You may recall that, in establishing the ranges in February and reviewing them in July, the Committee took note of the substantial uncertainties regarding the relationships between income and money in 1992 Although the velocity of the broad monetary aggregates--the ratio of nominal GDP to the quantity of money--had not changed much in 1991, that result itself was surprising. In the past, when market interest rates declined, as they had in 1991, savers shifted funds into M2, since deposit rates usually did not fall as much as market rates, and this produced a decline in velocity, in contrast to what occurred in 1991 As we moved into 1992, there appeared to be an appreciable likelihood that unusual weakness in M2 growth relative to spending would continue But, in the absence of convincing evidence for increases in velocity, the FOMC elected to leave the ranges unchanged from the previous year, noting that it would need to be flexible in assessing the implications of monetary growth relative to the ranges

In the event, nominal GDP was even stronger relative to the broad aggregates in 1992 than seemed likely when their ranges were established Income increased 3-1/2 percent faster than M2 over the year and 4-3/4 percent faster than M3. The unusual nature of these increases in velocity can be illustrated by noting that, prior to 1992, the velocity of M3 had risen more than 3 percent in a year only once, the historical increases in M2 velocity comparable to last year's occurred solely in the context of sizable increases in market interest rates, in contrast to last year's declines

What accounts for this unusual behavior? Why is it that our financial system was able to support 5-1/2 percent growth in nominal GDP with only 2 percent growth in M2 and 1/2 percent growth in M3? We can't be entirely certain we have all the answers, but certain elements of our evolving financial picture clearly have played a major role. The most important, perhaps, was that savers believed they could earn considerably more on their funds if they were invested in something other than the deposits and money market mutual funds that make up M2 The unprecedented steepness of the yield curve was one factor contributing to the apparent rate disadvantage of M2 assets The high level of long-term yields relative to shorter-term rates--rates on deposits, in particular--has attracted funds from bank and thrift deposits into alternative, longer-term investments For example, bond and stock mutual funds, which are not included in our standard monetary measures, flourished in 1992. Assets in those funds, excluding institutional holdings and IRA and Keogh accounts, increased $125 billion In the absence of such growth, a sizable proportion of the additional shares doubtless would have resided in deposits. Shifts from deposits to mutual funds have been abetted by the spread of facilities in banks and thrifts to sell mutual funds directly to their customers

In addition, the high relative cost of consumer debt, which has resulted partly from the elimination of the tax deductibility of consumer interest expenses, no doubt has prompted households to use funds that otherwise would be held in M2 to pay off, or avoid taking on, consumer debt Mortgage interest rates also are high compared with interest rates on deposits, reflecting the steep yield curve This relationship has led some households to repay mortgage debt with funds that might otherwise be held in deposits

Of course, if banks and thrifts had been expanding their loan portfolios, they would have had to bid more vigorously for deposits. But a number of developments damped growth of bank and thrift credit, and depositories consequently have been prompt to reduce rates on deposits In the business sector, the higher levels of stock and bond prices have encouraged many corporations to pay down bank debt with the proceeds of a large volume of bond and stock offerings. More generally, the attitudes of households and firms toward debt and leverage appear to have changed considerably in recent years, perhaps in part mirroring revised expectations about prospects for inflation to ease debt burdens or reward leverage

The supplies of credit by depositories also have been constrained Incentives to lend have been damped by market and regulatory pressures for depository institutions to increase capital ratios, as well as by other factors raising their costs of intermediating credit, such as higher deposit insurance premiums, rising regulatory costs, and more stringent supervisory oversight As a result, banking and thrift institutions have sought to limit balance-sheet growth or actually to shrink.

Together, these supply and demand factors have accelerated a long-standing process of rechannelling credit flows outside of depository institutions. With reduced needs to fund asset growth, banks and thrifts have bid less vigorously for deposits, as can be observed in the very low returns on such instruments These low yields, as I have noted, provide incentives for depositors to redirect cash toward alternative investments and repayment of debt In addition, the proceeds of banking firms' offerings of equity shares and subordinated debt have substituted for banks' deposit funding and have thus reduced monetary growth

The adjustments in our depository sector have significant implications for the overall operation of the financial system and the performance of the economy Historically, banking institutions have played a critical role in financing small and medium-sized businesses--firms that in the past have been a key source of growth in the economy Some of the factors leading to the relative shrinkage of our banking industry, by limiting the availability of credit to smaller firms, have restrained aggregate demand and thus have significantly hindered the economic expansion

Nevertheless, the financial markets have shown a remarkable capacity to adjust to the contraction of the depository sector in a way that mutes the impact on the overall economy For instance, despite a massive contraction in the thrift industry since 1988, housing credit has remained readily available and, in fact, relatively inexpensive as a result of the further exploitation of financial innovations such as mortgage-related securities. Similarly, open market sources of funds have flourished in recent years, allowing many firms to tap the stock or bond markets to restructure their balance sheets

As a result of such adaptations, the relationship between money and the economy may be undergoing a significant transformation In contrast to earlier work that suggested a stable long-run relationship between M2 growth and inflation, recent developments may indicate that the velocities of the broader monetary aggregates are moving toward higher trend levels It may be that the opening of securities markets to increasing numbers of borrowers and lenders--in part through securitization of loans by depositories as well as their offerings of mutual funds to deposit customers--is permanently shunting financing around depository institutions If this is true, the liabilities of these institutions will not be as good a gauge of financial conditions as they once were

This is not to argue that money growth can be ignored in formulating monetary policy The Federal Reserve in 1992 paid substantial attention to developments in the money supply, and we will continue to do so in 1993 and beyond Selecting ranges for monetary growth over the coming year consistent with desired economic performance, however, is especially difficult when the relationship between money and income has become uncertain Recent experience suggests that, at least for a time, measuring money against such ranges may lead to erroneous conclusions regarding the stance of monetary policy

The shortfall of the aggregates from their ranges and suggestions that the Federal Reserve should have been more vigorous in preventing the shortfall have raised the general question of the role of the ranges in conducting monetary policy The annual ranges for money and credit growth can be useful in communicating to the Congress and the public the Federal Reserve's plans for monetary policy and their relationship to the country's broader economic objectives Lowering the ranges during the 1980s, for instance, served as an important signal of the anti-inflationary commitment of the Federal Reserve.

In some circumstances, the monetary aggregates can also be of value by serving as indicators of the thrust of monetary policy Deviations of money growth from expectations may well signal that policy is not having its intended effect, and that adjustments should be considered Over much of our nation's financial history a number of measures of the money supply had reasonably predictable relationships with aggregate income The period of rapid financial change had not yet begun, and measuring money was more straightforward. Recognition of these predictable money-income relationships was the basis for the Federal Reserve's increased emphasis on money in the 1970s and the subsequent Humphrey-Hawkins legislation And at the beginning of the 1980s, the Congress passed the Monetary Control Act and the Federal Reserve adopted procedures to provide greater assurance that targets for M1 could be achieved

But, even by the mid-1970s, the relationship of the monetary aggregates to the economy was becoming more complex. Financial innovation and deregulation significantly altered the spectrum of available transaction and saving instruments In the mid-1970s, advances in corporate cash management techniques, such as sweep accounts, reduced the need for business demand deposit balances for any given level of transactions And in the early 1980s, the widespread availability of NOW accounts--transactions accounts that pay interest--led households to treat their checking accounts to some degree as savings instruments and to shift funds in and out of such accounts mainly on the basis of interest rate relationships Such developments primarily affected M1 The FOMC made repeated adjustments to its M1 range to take account of changing velocity and soon after the mid-1980s had eliminated its target for this aggregate Many of the shifts were captured within the broader aggregates, but adjustments to their ranges also had to be made from time to time

In the last few years, the broader aggregates in turn have become much less reliable guides for the conduct of policy Eventually, these measures may resume a more stable relationship with the economy, or experience may suggest useful new definitions for the aggregates We are currently investigating several possible alternative measures But, in the meanwhile, the FOMC necessarily has given less weight to monetary aggregates in the conduct of policy and has relied on a broad range of indicators of future financial and economic developments and price pressures And, in particular, the FOMC judged in 1992 that more determined efforts to push the aggregates into their ranges would not have been consistent with achieving the nation's longer-term objective of maximum sustainable economic growth Indeed, had there been an attempt to force M2 and M3 toward the middle of their ranges, intermediate- and long-term rates by now might have been significantly higher than they are currently, threatening the durability of the expansion

This use of a broad range of indicators is appropriate because achievement of the ranges for growth of particular measures of money and credit is not, and should not be, the objective of monetary policy Rather, the ranges are a means to an end The Humphrey-Hawkins Act, incorporating this view, does not require that the ranges be attained in circumstances in which doing so would not be consistent with achieving the more fundamental economic objectives

Ranges for Money and Credit for 1993

In establishing ranges for the monetary and credit aggregates in the current year, the FOMC took into account the likelihood that many of the factors that have acted in recent years to restrain money and credit growth relative to income would continue, though perhaps with somewhat diminishing intensity. The yield curve could well remain steep, absent very marked progress in deficit reduction or a distinct break in long-term inflation expectations, which would tend to lower long-term interest rates. Banking and thrift institutions are unlikely to step up the pace of balance-sheet expansion sharply, and the large volume of securities they have accumulated in recent years will allow them to fund a pickup in loan growth without as marked an acceleration of deposit growth. And households and firms are expected to continue to be relatively cautious in their use of credit Other factors may add to tendencies for money to expand more slowly than income For example, a resumption of resolutions by the Resolution Trust Corporation, which has been inactive for nearly a year, by shifting assets from thrifts onto government balance sheets, would tend to substitute federal liabilities for those of thrift institutions, reducing monetary growth

Reflecting the expectation that sluggish monetary growth will be associated with sustainable expansion in the economy, the Federal Open Market Committee has elected to reduce the ranges for M2 and M3 for 1993 by one-half percentage point For M2, a range of 2 to 6 percent, measured as usual on a fourth-quarter-to-fourth-quarter basis, was established A range of 1/2 to 4-1/2 percent was specified for M3

As I have indicated in correspondence with members of the Congress, the FOMC does not view the reductions in the monetary ranges as signalling a change in the stance of monetary policy. And most emphatically, these reductions do not indicate a desire on the part of the Federal Reserve to thwart the expansion The Federal Reserve, to the contrary, is endeavoring to conduct monetary policy in a way that promotes sustainable economic expansion. The lowering of these ranges does not imply any change in our fundamental objectives The necessity for a reduction in the monetary ranges at this time is wholly technical in nature, and is a result of the forces that are altering the money-income relationship. Consistent with this view, the FOMC decided to maintain a range of 4-1/2 to 8-1/2 percent for domestic nonfinancial sector debt, an aggregate whose relationship with nominal GDP has been less distorted in the last few years than that of the monetary aggregates

Significant uncertainties regarding the appropriate ranges for monetary growth remain While we have made some progress in understanding the behavior of the money and credit aggregates over the past year, to a degree this increased understanding has reinforced our appreciation of the complexity--and limited predictability--of the economic and financial relationships that affect money growth and its linkages with the economy

These uncertainties imply that the relationship between money and GDP growth could turn out significantly different from what currently seems likely Accordingly, the Federal Reserve again will interpret the growth of money and credit relative to their ranges in the context of other indicators of the financial system, the performance of the economy, and prices. Should recent trends affecting the money-income relationship continue, growth of the monetary aggregates in the lower portions of their ranges might be expected On the other hand, the upper ends of the ranges provide ample room for adequate monetary growth should demands for money relative to income come more into line with historical patterns In any event, until the relationship between the monetary aggregates and spending returns to a more reliable basis, flexibility in the interpretation of the aggregates relative to their new ranges is required.

Economic Outlook for 1993

Several of the forces affecting relationships between money and income also complicate the task of assessing the economic outlook itself. For example, the prospects for an easing of supply restrictions on credit from banks and other intermediaries are difficult to assess, but any major change in this situation could have important implications for the economy While banking institutions have become much more healthy and are well-positioned to meet an increase in loan demand, very few signals of any easing of terms or standards on business loans have been apparent to date

In addition, other factors that hobbled the economy in the last several years are likely to persist in 1993, though perhaps with diminished intensity. Households and business are likely to remain cautious in using credit--a healthy development for sustained growth, but potentially continuing to constrain spending in the short run Sizable imbalances in commercial real estate remain, and a significant rebound in this sector is doubtless several years off Government spending at the federal, state, and local levels is likely to remain constrained. A number of foreign nations are confronting slow economic growth or recession, which is likely to hold back demand for our exports And it is apparent from recent announcements by several large firms that corporate restructuring, involving significant cutbacks in operations and employment, is continuing

Another very considerable uncertainty in the economic outlook is fiscal policy The Congress and the Administration are considering both short-run fiscal stimulus and steps to reduce the deficit in the long run Obviously, government spending and taxes could be affected by such measures in such a way as to influence directly the overall economy this year, although the bulk of any effect likely would occur in succeeding years In addition, depending on the timing, dimensions, and credibility of any fiscal measures, market interest rates and stock prices could be affected appreciably, with implications for private expenditures

While uncertainties thus remain, the economy appears to have entered the year with noticeable momentum to spending In addition, inventories are at relatively low levels, and factory orders have been rising Consumer confidence has recovered, and spending on durables and homes appears to be moving at a brisker pace Recent surveys suggest an appreciable increase in business investment this year

Against this background, members of the Board and Federal Reserve Bank presidents project a further gain in economic activity in 1993 The central tendency of our projections is for real GDP to increase at a 3 to 3-1/4 percent rate this year. Such an increase should result in a decline in the unemployment rate, which would be expected to finish 1993 at a level of 6-3/4 to 7 percent. Inflation is expected to remain low this year

Containing, and over time eliminating, inflation is a key element in a strategy to foster maximum sustainable long-run growth of the economy As I have often emphasized, monetary policy, by achieving and maintaining price stability, can foster a stable economic and financial environment that is conducive to private economic planning, savings, investment, and economic growth It is no accident that the periods in our nation's history of low inflation were the times when the economy experienced high rates of private saving, investment, and hence productivity and economic growth When inflation is low, endeavors to boost profit margins necessarily involve reductions in cost rather than increasing prices; thus, low rates of inflation tend to be associated with relatively high productivity growth. Conversely, periods of high and rising inflation here and abroad have been characterized by financial instability, an excessive amount of resources devoted to protecting financial wealth rather than production of goods and services, and substandard economic growth

Over the past decade or so, our nation has made very substantial progress toward the achievement of price stability, reversing a dangerous upward trend of inflation and inflationary expectations Last year's 3-1/4 percent increase in the core CPI was the lowest in twenty years and far lower than the debilitating double-digit rates at the close of the 1970s As I have indicated to this Committee on numerous occasions, price stability does not require that measured inflation literally be zero, but rather is achieved when inflation is low enough that changes in the general price level are insignificant for economic and financial planning. At current inflation rates, we are thus quite close to attaining this goal

Going forward, the strategy of monetary policy will be to provide sufficient liquidity to support the economic expansion while containing inflationary pressures The existing slack implies that the economy can grow more rapidly than potential GDP for a time, permitting further reductions in the unemployment rate even while inflation is contained

Implementing this strategy, however, will be challenging Judging the level of potential output and its rate of growth is difficult Recent increases in productivity have been unusually strong, given the moderate pace of economic growth during much of the expansion, and it is unclear whether these rates of productivity gain can be continued. In addition, the monetary aggregates do not appear to be giving reliable indications of economic developments and price pressures, and numerous other uncertainties cloud the particular features of the outlook Monetary policy will have to adjust to unexpected developments as they occur, taking into account a variety of economic and financial indicators

The contributions that monetary policy can make to maximum sustainable economic growth would be complemented by a fiscal policy focused on long-term deficit reduction In the current environment, reducing the federal government's drain on scarce savings would take pressure off long-term interest rates, facilitating the readjustment of balance sheets and helping to promote capital formation and more robust economic growth over the longer term

The Federal Reserve, in formulating monetary policy, certainly needs to take into account fiscal policy developments Of course, it is not possible for the Federal Reserve to specify in advance what actions might be taken in the presence of particular fiscal policy strategies. Clearly, the course of interest rates and financial market conditions more generally will depend importantly on a host of forces--in addition to fiscal policy--affecting the economy and prices And the effects of fiscal policy on the economy in turn will depend importantly on the credibility of long-run deficit reduction and the market reaction to any package. The lower long-term interest rates that resulted from a credible deficit-reduction plan would themselves have an immediate positive effect on the economy In any event, I can assure you of our shared goal for the American economy--the greatest possible increase in living standards for our citizens over time.

The last several years have been difficult, and the economy is still adjusting to structural imbalances that have built up over recent decades The near-term outlook, as always, is somewhat uncertain But I believe that in many respects the inevitable painful adjustments have laid the foundation for better performance of our economy over the longer term Financial positions have been strengthened; inflation is low and should remain subdued; labor productivity is increasing, resources are being shifted from national defense to investment and consumption. Nevertheless, the challenges ahead for policymakers will be considerable While continuing to be supportive of the expansion of our economy over coming quarters, the monetary and fiscal authorities alike need to structure our policies to enable our economy to reach its full potential over time