For use at 9 45 a m EDT
Tuesday
July 20, 1993

Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Economic Growth and Credit Formation

of the

Committee on Banking, Finance and Urban Affairs

U S House of Representatives

July 20, 1993

Thank you for this opportunity to discuss the Federal Reserve's semiannual monetary policy report to the Congress My remarks this morning will cover the current monetary policy and economic settings, as well as the Federal Reserve's longer-term strategy for contributing, to the best of our abilities, to the nation's economic well-being

As the economic expansion has progressed somewhat fitfully, our earlier characterization of the economy as facing stiff head winds has appeared increasingly appropriate Doubtless the major head wind in this regard has been the combined efforts of households, businesses, and financial institutions to repair and to rebuild their balance sheets following the damage inflicted in recent years as weakening asset values exposed excessive debt burdens

But there have been other head winds as well The build-down of national defense has cast a shadow over particular industries and regions of the country Spending on nonresidential real estate dropped dramatically in the face of overbuilding and high vacancy rates and has remained in the doldrums At the same time, corporations across a wide range of industries have been making efforts to pare employment and expenses in order to improve productivity and their competitive positions These efforts have been prompted in part by innovative technologies, which have been applied to almost every area of economic endeavor, and have boosted investment However, their effect on jobs and wages through much of the expansion also has made households more cautious spenders

In the past several years, as these influences have restrained the economy, they have been balanced in part by the accommodative stance of monetary policy and, more recently, by declines in longer-term interest rates as the prospects for credible federal deficit cuts improved From the time monetary policy began to move toward ease in 1989 to now, short-term interest rates have dropped by more than two-thirds and long-term rates have declined substantially, too All along the maturity spectrum, interest rates have come down to their lowest levels in twenty or thirty years, aiding the repair of balance sheets, bolstering the cash flow of borrowers, and providing support for interest-sensitive spending

The process of easing monetary policy, however, had to be closely controlled and generally gradual, because of the constraint imposed by the marketplace's acute sensitivity to inflation As I pointed out in my February testimony to the Congress, this is a constraint that did not exist in an earlier time Before the late 1970s, financial market participants and others apparently believed that, while inflationary pressures might surface from time to time, the institutional structure of the U S economy simply would not permit sustained inflation But as inflation and, consequently, long-term interest rates soared into the double digits at the end of the 1970s, investors became painfully aware that they had underestimated the economy's potential for inflation. As a result, monetary policy in recent years has had to remain alert to the possibility that an ill-timed easing could be undone by a flare-up of inflation expectations, pushing long-term interest rates higher, and short-circuiting essential balance sheet repair

The cumulative monetary easing over the last four years has been very substantial Since last September, however, no further steps have been taken, as the stance of policy has appeared broadly appropriate to the evolving economic circumstances

That stance has been quite accommodative, especially judging by the level of real short-term interest rates in the context of, on average, moderate economic growth Short-term real interest rates have been in the neighborhood of zero over the last three quarters In maintaining this accommodative stance, we have been persuaded by the evidence of persistent slack in labor and product markets, increasing international competitiveness, and the decided absence of excessive credit and money expansion The forces that engendered past inflationary episodes appear to have been lacking to date

Yet some of the readings on inflation earlier this year were disturbing It appeared that prices might be accelerating despite product market slack and an unemployment rate noticeably above estimates of the so-called "natural" rate of unemployment--that is, the rate at which price pressures remain roughly constant In the past, the existing degree of slack in the economy had been consistent with continuing disinflation

However, the inflation outcome, history tells us, depends not only on the amount of slack remaining in labor and product markets, but on other factors as well, including the rate at which that slack is changing If the economy is growing rapidly, inflation pressures can arise, even in the face of excess capacity, as temporary bottlenecks emerge and as workers and producers raise wages and prices in anticipation of continued strengthening in demand Near the end of last year, about the time many firms probably were finalizing their plans for 1993, sales and capacity utilization were moving up markedly and there was a surge of optimism about future economic activity This may well have set in motion a wave of price increases, which showed through to broad measures of prices earlier this year

Moreover, inflation expectations, at least by some measures, appear to have tilted upward this year, possibly contributing to price pressures The University of Michigan survey of consumer attitudes, for example, reported an increase in the inflation rate expected to prevail over the next 12 months from about 3-3/4 percent in the fourth quarter of last year to nearly 4-1/2 percent in the latest quarter Preliminary data imply some easing of such expectations earlier this month, but the sample from which those data are derived is too small to be persuasive Moreover, the price of gold, which can be broadly reflective of inflationary expectations, has risen sharply in recent months And at times this spring, bond yields spiked higher when incoming news about inflation was most discouraging

The role of expectations in the inflation process is crucial Even expectations not validated by economic fundamentals can themselves add appreciably to wage and price pressures for a considerable period, potentially derailing the economy from its growth track

Why, for example, despite an above-normal rate of unemployment and permanent layoffs, have uncertainties about job security not led to further moderation in wage increases? The answer appears to lie at least in part in the deep-seated anticipations understandably harbored by workers that inflation is likely to reaccelerate in the near term and undercut their real wages

The Federal Open Market Committee (FOMC) became concerned that inflation expectations and price pressures, unless contained, could raise long-term interest rates and stall economic expansion Consequently, at its meeting in May, while affirming the more accommodative policy stance in place since last September, the FOMC also deemed it appropriate to initiate a so-called asymmetric directive Such a directive, with its bias in the direction of a possible firming of policy over the intermeeting period, does not prejudge that action will be taken--and indeed none occurred But it did indicate that further signs of a potential deterioration of the inflation outlook would merit serious consideration of whether short-term rates needed to be raised slightly from their relatively low levels to ensure that financial conditions remained conducive to sustained growth

Certainly the May and June price figures have helped assuage concerns that new inflationary pressures had taken hold Nonetheless, on balance, the news on inflation this year must be characterized as disappointing Despite disinflationary forces and continued slack, the rate of inflation has at best stabilized, rather than easing further as past relationships would have suggested

In assessing the stance of monetary policy and the likelihood of persistent inflationary pressures, the FOMC took account of the downshift in the pace of economic expansion earlier this year This downshift left considerable remaining slack in the economy and promised that the adverse price movements prompted by the acceleration in growth late last year likely would diminish

While a slowdown from the unsustainably rapid growth in the latter part of last year had been anticipated, the deceleration was greater than expected A surprisingly precipitous drop in defense spending, a sharp deterioration in net exports, a major blizzard, and some inevitable retrenchment by consumers converged to yield only meager gains in output in the first quarter But growth apparently picked up in the second quarter, and nearly one million net new jobs were created over the first half Smoothing through the quarterly pattern, the economy appears to have accelerated gradually over the past two years, to maintain a pace of growth that should yield further reductions in the unemployment rate Consequently, the evidence remains consistent with our diagnosis that the underlying forces at work are keeping the economy generally on a moderate upward track However, as I have often emphasized, not all the old economic and financial verities have held in the current expansion, and changes in fiscal policy will have uncertain effects going forward Thus, caution in assessing the path for the economy remains appropriate

Financial conditions have improved considerably, lessening the need for balance sheet restructuring that has been damping economic activity for several years now By no means is the process over, but good progress has been made Debt service burdens, eased by lower interest rates and lower debt-equity ratios, have fallen substantially in both the business and household sectors On the other hand, the economies of a number of our major trading partners have been quite weak, constraining the growth of demand for our exports

Although expectations of a significant, credible decline in the budget deficit have induced lower long-term interest rates and favorably affected the economy, the positive influence thus far is apparently being at least partly offset by some business spending reductions as a consequence of concerns about the effects of pending tax increases

It seems that the *prospective* cuts in the deficit are having a variety of substantial economic effects, well in advance of any *actual* change in taxes or in projected outlays Moreover, uncertainty about the final shape of the package may itself be injecting a note of caution into private spending plans In addition, uncertainty about the outlook for health care reform may be affecting spending at least by that industry

To be sure, the conventional wisdom is that budget deficit reduction restrains economic growth for a time, and I suspect that probably is correct However, over the long run, such wisdom points in the opposite direction In fact, one can infer that recent declines in long-term interest rates are bringing forward some of these anticipated long-term gains As a consequence, the timing and magnitude of any net restraint from deficit reduction is uncertain Patently, the overall economic effect of fiscal policy, especially when combined with the uncertainties of the forthcoming health reform package, has imparted a number of unconventional unknowns to the economic outlook

Assuming, however, we constructively resolve over time the major questions about federal budget and health care policies, with the further waning of earlier restraints on growth, the U S economy should eventually emerge healthier and more vibrant than in decades The balance sheet restructuring of both financial and nonfinancial establishments in recent years should leave the various sectors of the economy in much better shape and better able to weather untoward developments Similarly, the ongoing efforts by corporations to pare expenses are putting our firms and our industries in a better position to compete both within the U S market and globally And after a period of some dislocation, the contraction in the defense sector ultimately will mean a freeing up of resources for more productive uses Finally, a credible and effective fiscal package would promise an improved outlook for sustained lower long-term interest rates and a better environment for private sector investment All told, the productive capacity of the economy will doubtless be higher, and its resilience greater

Over the last two years, the forces of restraint on the economy have changed, but real growth has continued, with one sector of the economy after another taking the lead Against this background, Federal Reserve Board governors and Reserve Bank presidents project that the U S economy will remain on the moderate growth path it has been following as the expansion has progressed Their forecasts for real GDP average around 2-1/2 percent from the fourth quarter of 1992 to the fourth quarter of 1993, and cluster around 2-1/2 to 3-1/4 percent over the four quarters of 1994 Reflecting this moderate rise and the outlook for labor productivity, unemployment is generally expected to edge lower, to around 6-3/4 percent by the end of this year, and to perhaps a shade lower by the end of next year For this year as a whole, FOMC participants see inflation at or just above 3 percent, and most of them have about the same forecast for next year

In addition to focusing on the outlook for the economy at its July meeting, the FOMC, as required by the Humphrey-Hawkins Act, set ranges for the growth of money and debt for this year and, on a preliminary basis, for 1994 One premise of the discussion of the ranges was that the uncharacteristically slow growth of the broad monetary aggregates in the last couple of years--and the atypical increases in their velocities--would persist for a while longer M2 has been far weaker than income and interest rates would predict Indeed, if the historical relationships between M2 and nominal income had remained intact, the behavior of M2 in recent years would have been consistent with an economy in severe contraction To an important degree, the behavior of M2 has reflected structural changes in the financial sector The thrift industry has downsized by necessity, and commercial banks have pulled back as well, largely reflecting the burgeoning loan losses that followed the lax lending of earlier years With depository credit weak, there has been little bidding for deposits, and depositors in any case have been drawn to the higher returns on capital market instruments Inflows to bond and stock mutual funds have reached record levels, and, to the extent that these inflows have come at the expense of growth in deposits or money market mutual funds, the broad monetary aggregates have been depressed

In this context, the FOMC lowered the 1993 ranges for M2 and M3--to 1 to 5 percent and 0 to 4 percent, respectively This represents a reduction of 1 percentage point in the M2 range and 1/2 percentage point for M3 Even with these reductions, we would not be surprised to see the monetary aggregates finish the year near the lower ends of their ranges

As I emphasized in a similar context in February, the lowering of the ranges is purely a technical matter, it does not indicate, nor should it be perceived as, a shift of monetary policy in the direction of restraint It is indicative merely of the state of our knowledge about the factors depressing the growth of the aggregates relative to spending, of the course of the aggregates to date, and of the likelihood of various outcomes through the end of the year While the lowering of the range reflects our judgment that shifts out of M2 will persist, the upper end of the revised range allows for a resumption of more normal behavior or even some unwinding of M2 shortfalls The FOMC also lowered the 1993 range for debt of the domestic nonfinancial sectors, by 1/2 percentage point, to 4 to 8 percent The debt aggregate is likely to come in comfortably within its new range, as it continues growing about in line with nominal GDP The new ranges for growth of money and debt in 1993 were carried over on a preliminary basis into 1994

In reading the longer-run intentions of the FOMC, the specific ranges need to be interpreted cautiously The historical relationships between money and income, and between money and the price level have largely broken down, depriving the aggregates of much of their usefulness as guides to policy At least for the time being, M2 has been downgraded as a reliable indicator of financial conditions in the economy, and no single variable has yet been identified to take its place

At one time, M2 was useful both to guide Federal Reserve policy and to communicate the thrust of monetary policy to others Even then, however, a wide range of data was routinely evaluated to assure ourselves that M2 was capturing the important elements in the financial system that would affect the economy The FOMC never single-mindedly adhered to a narrow path for M2, but persistent and sizable deviations of that aggregate from expectations were a warning sign that policy and the economy might not be interacting in a way that would produce the desired results The so-called "P-star" model, developed in the late 1980s, embodied a long-run relationship between M2 and prices that could anchor policy over extended periods of time But that long-run relationship also seems to have broken down with the persistent rise in M2 velocity

M2 and P-star may reemerge as reliable indicators of income and prices once the yield curve has returned to a more normal configuration, borrowers' balance sheets have been restored and traditional credit demands resume, savers have adjusted to the enhanced availability of alternative investments, and depositories finally reach a comfortable size relative to their capital and earnings In the meantime, the process of probing a variety of data to ascertain underlying economic and financial conditions has become even more essential to formulating sound monetary policy This general approach obviously has its weaknesses When examining many indicators, some can always be found that counsel against actions that later appear to have been necessary

In these circumstances, it is especially prudent to focus on longer-term policy guides One important guidepost is real interest rates, which have a key bearing on longer-run spending decisions and inflation prospects

In assessing real rates, the central issue is their relationship to an equilibrium interest rate, specifically the real rate level that, if maintained, would keep the economy at its production potential over time Rates persisting above that level, history tells us, tend to be associated with slack, disinflation, and economic stagnation--below that level with eventual resource bottlenecks and rising inflation, which ultimately engenders economic contraction Maintaining the real rate around its equilibrium level should have a stabilizing effect on the economy, directing production toward its long-term potential

The level of the equilibrium real rate--or more appropriately the equilibrium term structure of real rates--cannot be estimated with a great deal of confidence, though with enough to be useful for monetary policy Real rates, of course, are not directly observable, but must be inferred from nominal interest rates and estimates of inflation expectations The most important real rates for private spending decisions almost surely are the longer maturities. Moreover, the equilibrium rate structure responds to the ebb and flow of underlying forces affecting spending So, for example, in recent years the appropriate real rate structure doubtless has been depressed by the head winds of balance sheet restructuring and fiscal retrenchment Despite the uncertainties about the levels of equilibrium and actual real interest rates, rough judgments about these variables can be made and used in conjunction with other indicators in the monetary policy process Currently, short-term real rates, most directly affected by the Federal Reserve, are not far from zero, long-term rates, set primarily by the market, are appreciably higher, judging from the steep slope of the yield curve and reasonable suppositions about inflation expectations This configuration indicates that market participants anticipate that short-term real rates will have to rise as the head winds diminish, if substantial inflationary imbalances are to be avoided

While the guides we have for policy may have changed recently, our goals have not As I have indicated many times to this Committee, the Federal Reserve seeks to foster maximum sustainable economic growth and rising standards of living And in that endeavor, the most productive function the central bank can perform is to achieve and maintain price stability

Inflation is counterproductive in many ways Of particular importance, increased inflation has been found to be associated with reduced growth of productivity, apparently in part because it confounds relative price movements and obscures price signals Compounding this negative effect, under the current tax code, inflation raises the effective taxation of savings and investment, discouraging the process of capital formation Since productivity growth is the only source of lasting increases in real incomes and because even small changes in growth rates of productivity can accumulate over time to large differences in living standards, its association with inflation is of key importance to policymakers

The link between the control of inflation and the growth of productivity underscores the importance of providing a stable backdrop for the economy Such an environment is especially important for an increasingly dynamic market economy, such as ours, where technology and telecommunications are making rapid advances New firms, new products, new jobs, new industries, and new markets are continually being created, and they are unceremoniously displacing the old ones The U S economy is a dynamic system, always renewing itself It is extraordinary that the system overall is as stable as it is, considering the persistent process of change in the structure of our economy For example, a frequently cited figure is the two million new jobs that have been created since the end of 1991 This is a net change, however, which masks the many millions who found, lost, and changed jobs over the same period Currently, people are being hired at a pace of approximately 400,000 per week, with job losses running modestly below that figure Such vast churning in the nation's labor markets is a normal and ultimately a productive process

Central planning of the type that prevailed in post-war Eastern Europe and the Soviet Union represented one attempt to fashion an economic system that eliminated this competitive churning and its presumed wastefulness But when that system eliminated the risk of failure, it also stifled the incentive to innovate and to prosper Central planning fostered stasis In many respects, the eastern-bloc economies marched in place for more than four decades

Risk-taking is crucial in the process that leads to a vital and progressive economy Indeed, it is a necessary condition for wealth creation In a market economy, competition and innovation interact, those firms that are slow to innovate or to anticipate the demands of the consumer are soon left behind The pace of churning differs by industry, but it is present in all At one extreme, firms in the most high-tech areas must remain constantly on the cutting edge, as products and knowledge become rapidly obsolete Many products that were at technology's leading edge, say five years ago, are virtually unsalable in today's markets In high-tech fields, leadership can shift rapidly In some markets where American firms were losing share just a few years ago, we have regained considerable dominance In one case, U S firms have seized a commanding lead in just two years in the new laptop computer market, and now account for more than 60 percent of U S sales last year, triple the figure for Japanese firms

More generally, it appears that the pace of dynamism has been accelerating. As one indication, the average economic life expectancy of new capital equipment has been falling The average life of equipment purchased in 1982, for example, was 16-1/2 years By 1992 that figure had declined to 14-1/2 years, a drop more than twice as large as that over the preceding decade. In addition, telecommunications technology is obviously quickening the decision-making process in both financial and product markets

In such a rapidly changing marketplace, the agile survive by being flexible One aspect of this flexibility has been the spread of "just-in-time" inventory controls at manufacturing firms Partly as a result of innovations in inventory control techniques, the variability of inventories relative to total output appears to be on a downtrend

The possibility of failure has productive side effects, encouraging economic agents to do their best to succeed But there are nonproductive and unnecessary risks as well There is no way to avoid risk altogether, given the inherently uncertain outcomes of all business and household decisions But many uncertainties and risks do not foster economic progress, and where feasible should be suppressed A crucial risk in this category is that induced by inflation To allow a market economy to attain its potential, the unnecessary instability engendered by inflation must be quieted

A monetary policy that aims at price stability permits low long-term interest rates and helps provide a stable setting to foster the investment and innovation by the private sector that are key to long-run economic growth In pursuing our objectives, we must remain acutely aware that the structure of the economy has been changing and growing ever more complex The relationships between the key variables in the economy are always shifting to a degree, and this evolution presents an ongoing challenge to the business leader, to the econometric modeler, and to those responsible for the conduct of economic policy

Clearly, the behavior of many of the forces acting on the economy over the course of the last business cycle have been different from what had gone before The sensitivity of inflation expectations has been heightened, and, as recent evidence suggests, businesses and households may be becoming more forward-looking with respect to fiscal policies as well

I believe we are on our way toward reestablishing the trust in the purchasing power of the dollar that is crucial to maximizing and fulfilling the productive capacity of this nation The public, however, clearly remains to be convinced Survey responses and financial market prices embody expectations that the current lower level of inflation not only will not be bettered, it will not even persist But there are glimmers of hope that trust is reemerging For example, issuers have found receptive markets in recent months for fifty-year bonds This had not happened in decades The reopening of that market may be read as one indication that some investors once again believe that inflationary pressures will remain subdued

It is my firm belief that, with fiscal consolidation and with the monetary policy path that we have charted, the United States is well-positioned to remain at the forefront of the world economy well into the next century