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Testimony by

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking Housing, and Urban Affairs

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Mr Chairman and members of the Committee, I appreciate the opportunity to appear before you to discuss recent monetary policy

The Federal Reserve's moves to increase short-term interest rates this year are most appropriately understood in an historical context

In the spring of 1989, we began to ease monetary conditions as we observed the consequence of balance-sheet strains resulting from increased debt, along with significant weakness in the collateral underlying that debt Households and businesses became much more reluctant to borrow and spend, and lenders to extend credit--a phenomenon often referred to as the "credit crunch " In an endeavor to defuse these financial strains, we moved short-term rates lower in a long series of steps through the summer of 1992, and we held them at unusually low levels through the end of 1993--both absolutely and, importantly, relative to inflation These actions, together with those to reduce budget deficits, facilitated a significant decline in long-term rates as well

Lower interest rates fostered a dramatic improvement in the financial condition of borrowers and lenders Households rolled outstanding mortgage and consumer loans into much-lower-rate debt Business firms were able to pay down high-cost debt by issuing bonds and stocks on very favorable terms And banks, which had cut back on credit availability partly because of their own balance-sheet problems, were able to strengthen their capital positions by issuing a substantial volume of equity shares and other capital instruments and by retaining much of their improved flow of earnings Moreover, the lower interest rates, together with expanding economic activity, recently have bolstered the commercial real estate market, stemming

losses on the collateral underlying some of the largest problem credits of banks and other intermediaries and, in some cases permitting them to find purchasers for these assets

The sharp, sustained decline in debt-service charges and the restructuring of balance sheets alleviated the financial distress, enabling the economy to begin to move again in a normal expansionary pattern When I last testified before you on monetary policy in July 1993, the likelihood that the economy would soon respond more vigorously to these financial developments already was evident both to the Federal Reserve and to outside analysts Indeed, I mentioned that, with short-term real rates not far from zero, " market participants anticipate that short-term real interest rates will have to rise as the headwinds diminish if substantial inflationary imbalances are to be avoided " But lingering questions into the second half of 1993 about whether the economy had fully recuperated made the appropriate timing of such action unclear

Since the latter part of 1993, however, the expansionary effects of the monetary policy of the past few years have become increasingly apparent Although quarter-to-quarter developments are subject to considerable statistical noise, in an underlying sense real GDP clearly has accelerated Strength has been particularly evident in interest-sensitive sectors Business investment has been quite robust, and order books for producers of durable equipment have expanded appreciably Housing starts rose in the last three months of 1993 to their highest level in over four years, although they have dropped back some more recently, they remain 18 percent above a year ago Demand for motor vehicles has been strong, lifting production of many types of automobiles and light trucks to capacity Moreover, as

economic conditions have improved in other industrial countries, the growth of our merchandise exports has picked up markedly Overall industrial capacity utilization has increased to 83-1/2 percent its highest level since the late 1980s In excess of two million jobs have been created over the past twelve months, and the unemployment rate has fallen substantially

In this more robust financial and economic climate, expansion of money and credit has picked up Business loans--which had contracted over the 1990-93 period--grew at a 9-1/2 percent annual rate in the first four months of 1994 Bank lending to consumers also has been quite brisk The pickup in loan growth seems to reflect both stepped-up short-term credit demands as well as a greater willingness on the part of banks to extend credit Our surveys as well as anecdotal reports indicate that banks have been easing standards and terms on business loans for more than a year, and they have become more aggressive in seeking to extend consumer and residential mortgage loans The total debt of private borrowers and state and local governments, which had risen at only a 2-1/2 percent annual rate over the first half of 1993 accelerated to more than a 4-1/2 percent rate over the second half and has maintained the stronger pace during recent months Although ongoing portfolio adjustments have kept growth in M2 relatively sluggish, it has been increasing a little more quickly this year than last

Given the stronger economic and financial conditions, it became evident by early 1994 that the mission of monetary policy of the last few years had been accomplished The "headwinds" were substantially reduced, and the expansion appeared solid and self-sustaining

Having met our objective, we confronted the question of whether there was any reasonable purpose in maintaining the stimulative level of interest rates held throughout 1993. The answer to that question was no. Maintenance of that degree of accommodation, history shows, would have posed a risk of mounting inflationary pressures that we perceived as wholly unacceptable. Given the resumption of more normal patterns of economic activity and credit flows, a shift in policy stance was clearly indicated.

The question that remained was how to implement this shift. The economy looked quite robust, but we were concerned about the effects on financial markets of a rapid move away from accommodation. Short-term rates had remained unusually low for a long time, and long-term rates persisted well above short-term rates. The resulting attractiveness of holding stocks and bonds was further enhanced by a nearly unbroken stream of capital gains as long-term rates fell, which imparted the false impression that not only were returns on long-term investments quite high, but consistently so. The recovery of the stock market after the October 1987 crash, along with the successful fending off of any significant adverse consequences from that event may also have contributed to investor complacency. Moreover, in these extraordinary circumstances of persistent, low short-term interest rates, moderate growth in the economy, and gradually diminishing market concerns about future inflation, fluctuations in bond and stock prices around broader trends remained quite narrow by historical standards.

Thus, lured by consistently high returns in capital markets, people exhibited increasing willingness to take on market risk by extending the maturity of their investments. In retrospect, it is

evident that all sorts of investors made this change in strategy--from the very sophisticated to the much less experienced One especially notable feature of the shift was the large and accelerating pace of flows into stock and bond mutual funds in recent years In 1993 alone, $281 billion moved into these funds, representing the lion's share of net investment in the U S bond and stock markets A significant portion of the investments in longer-term mutual funds undoubtedly was diverted from deposits, money market funds, and other short-term, lower yielding, but less speculative instruments And, some of those buying the funds perhaps did not fully appreciate the exposure of their new investments to the usual fluctuations in bond and stock prices To the degree maturity extension was built on a false sense of security and certainty, it posed a risk to financial markets once that sense began to dissipate

Federal Reserve moves initiated in February along with a number of other developments in the United States and other major industrial economies in the same period were instrumental in radically altering perceptions of where interest rates were going and of the risk of holding longer-term assets In early February, we had thought long-term rates would move a little higher temporarily as we tightened, but that anticipation was in the context of expectations of a more moderate pace of economic activity both here and abroad than emerged shortly thereafter The sharp jump in rates that occurred appeared primarily to reflect the dramatic rise in market expectations of economic growth and associated concerns about possible future inflation pressures The behavior of interest rate spreads between Treasury and private debt--or credit risk premiums--in securities markets offers confirming evidence the fact that such spreads failed

to widen even as long-term interest rates rose dramatically suggests that the rise in long-term rates was seen by market participants as a consequence of a strong economy--not a precursor of a weak one Given the change in economic conditions, and the market s perception of them, longer-term rates eventually would have increased significantly even had the Federal Reserve done nothing this year

The rise in long-term rates has reflected increased uncertainty as well as expectations of a stronger economy While generally expected, the move from accommodation, interacting with the news on the domestic and global economy, triggered a re-examination by investors of their overly sanguine assumptions about price risk in longer-term financial assets As volatility and uncertainty increased, people began to reverse their previous maturity extensions They fled toward more price-certain investments at the short end of the yield curve For example, some flows into bond mutual funds were reversed, investors, fearing further rate increases and awakening to the nature of the risk they had taken on shifted funds back into shorter-term money market mutual funds and deposits The sales of securities by bond mutual funds likely contributed to pressures on yields, especially in markets in which they had been important buyers

Such reduced confidence about predictions of future interest rate movements evidently is a key element in explaining one of the more unusual characteristics of financial market developments in this recent period--the apparent degree of coupling of bond rates in many industrial countries facing different cyclical situations To be sure, part of the rise in long-term rates in other countries is accounted for by brighter economic prospects, especially in

Continental Europe and to some extent in Japan, so that market participants now expect less monetary policy ease in those regions.

But, added to this were the effects of additional uncertainty. In globalized financial markets, with investors having increasingly diversified portfolios across currencies, uncertainty, wherever it originates, can have similar effects on markets for securities denominated in a variety of currencies. When investors were confronted with a market environment they did not anticipate, they quickly disengaged not only from dollar assets, but from all investments that rested on a confident view of the future. The loss of confidence in one's ability to perceive the future does not discriminate between investments in dollar- or mark-denominated securities, for example. The process of disengaging largely resulted in sales of stocks and bonds with the proceeds placed in short-term debt instruments whose prices tend to be more stable. As a consequence long-term rates rose appreciably in most industrial countries. That the effects of decreased confidence partially overrode the differences in economic conditions between the United States and our major trading partners is evidence of the degree of uncertainty in financial markets.

Because we at the Fed were concerned about sharp reactions in markets that had grown accustomed to an unsustainable combination of high returns and low volatility, we chose a cautious approach to our policy actions, moving by small amounts at first. Members of the FOMC agreed that excess monetary accommodation had to be eliminated expeditiously, and a rapid shift would not in itself have been expected to destabilize the economy. We recognized, however, that our shift could impart uncertainty to markets, and many of us were concerned that a large immediate move in rates would create too big a dose of

uncertainty which could destabilize the financial system, indirectly affecting the real economy In light of the substantial variations in prices of financial assets over the last few months as we adjusted our posture, our worries seem to have been justified Delaying our actions would not have been constructive, unrealistic expectations would only have become more firmly embedded and the inevitable adjustment in the financial markets could have been far more difficult to contain Through this period, many of those who had purchased long-term securities with unduly optimistic expectations about the level and fluctuations in yields have made the needed adjustments Thus, we judged at our May 17th meeting that we could initiate a larger adjustment, without an undue adverse market reaction Indeed, markets reacted quite positively, on balance, perhaps because they saw timely action as reducing the degree and frequency of tightening that might be needed in the future

We initiated the removal of excess monetary accommodation without widespread indications that inflation has picked up To be sure, manufacturers have reported paying higher prices to suppliers, and prices of basic industrial commodities have risen a good deal in recent months. Moreover the behavior of the dollar on foreign exchange markets over the past several months has been a source of some concern But wage growth has remained moderate and unit labor costs well contained by marked improvements in productivity To date, underlying cost increases have been absorbed with little evidence that they have yet passed through into prices for final products

If we are successful in our current endeavors, there will not be an increase in overall inflation, and trends toward price stability

will be extended And to be successful, we must implement the necessary monetary policy adjustments in advance of the potential emergence of inflationary pressures, so as to forestall their actual occurrence Shifts in the stance of monetary policy influence the economy and inflation with a considerable lag, as long as a year or more The challenge of monetary policy is to interpret current data on the economy and financial markets with an eye to anticipating future inflationary or contractionary forces and to countering them by taking action in advance

The alternative--maintaining an accommodative monetary policy until inflation actually begins to pick up--would be detrimental to the best interests of our Nation's economy History unequivocally demonstrates that monetary accommodation when the economy is strong risks a significant acceleration of inflation Because of the lags in the effects of monetary policy, inflation once initiated would likely continue to rise for a time even after monetary policy began to tighten Inflationary expectations would begin to increase, influencing patterns of wage bargaining and interest rates As a result monetary policy would need eventually to tighten more sharply than if a more timely and measured approach is taken, possibly even placing the continuation of the economic expansion at risk Such go-stop policies--implying appreciable fluctuations in inflation rates and amplified business cycle swings--surely impede long-range economic planning saving, and investment, and diminish our economy's prospects for long-run growth and our ability to employ our growing labor force

We have attempted to avoid such an outcome by taking actions this year that have substantially removed the degree of accommodation that had been in place last year Our judgment was that with the

financial condition of both borrowers and lenders greatly improved, such action would not impede satisfactory economic growth, but rather would help such growth to be sustained Clearly, uncertainties regarding the economic outlook remain, and the Federal Reserve will need to monitor economic and financial developments to judge the appropriate stance of monetary policy. Our intention is to promote financial conditions under which our economy can grow at its greatest potential, consistent with steady, noninflationary expansion of employment and incomes