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Testimony by

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Board of Governors of the Federal Reserve System

before the

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

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 that ended in the late 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 federal 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. 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. By last summer, 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, in testimony to the Congress at that time 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 along with the healing of balance sheets have become increasingly apparent 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, there seemed no reasonable purpose in maintaining the demonstrably stimulative level of short-term interest rates held throughout 1993 Maintenance of that degree of accommodation, history shows, would have posed an unacceptable risk of mounting inflationary pressures Given the resumption of more normal patterns of economic activity and credit flows, a shift in policy stance was clearly indicated

In early February, we initiated the process of withdrawing the degree of monetary stimulus At the time, we 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 subsequent dramatic rise in market expectations of economic growth here and abroad and associated concerns about inflation provided considerable impetus to the sharp jump in rates Given the changes in economic conditions and prospects, 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, investors here and abroad 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 into 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.

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 Federal Open Market Committee agreed that excess monetary accommodation had to be eliminated expeditiously. We recognized, however, that our shift could impart uncertainty to financial 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

past few months as we adjusted our posture, our worries seem to have been justified. But, through this period, many of those who had purchased long-term securities with unduly optimistic expectations about the level and fluctuations in yields had 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, at that time, perhaps because they saw such timely action as reducing the degree and frequency of tightening that might be needed in the future.

Some critics of our latest policy actions have noted that we tightened policy even though inflation had not picked up. That observation is accurate, but is not relevant to policy decisions. To be successful, we must implement the necessary monetary policy adjustments well 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. Indeed, if we are successful in our current endeavors, there will not be an increase in overall inflation. The trends toward price stability will be extended in the context of sustainable growth in economic activity.

Mr. Chairman, in your letter of invitation, you raised a number of questions that relate to the issue of resource restraints and their influence on inflationary pressures. These relationships are not simple. High levels of resource utilization can contribute to

the process that ultimately produces destabilizing inflation, but they need not do so

Indeed, through much of this nation's history, we had periods of tightened labor and product markets with only transitory effects on the general price level. In these periods the discipline on credit expansion provided by the gold standard or other institutional arrangements limited the potential for prices to spiral upward and thus kept long-term inflation expectations from rising. After World War II, however, with those disciplines no longer in place, tightened markets became increasingly associated with rising inflation expectations and burgeoning credit demands, which we were sometimes too slow to counter. A persistent inflation, unprecedented in our history, eventually took hold, with devastating effects on our economy and society.

We still are paying a price for that episode despite major successes in reversing inflationary pressures during the past 15 years. There remains a significant inflation premium embodied in long-term interest rates, reflecting a still skeptical world financial market view that American fiscal and monetary policies retain some inflation bias. Until the late 1970s, the markets held a deep-seated though, in retrospect, naive view that the economic and institutional structure of the United States rendered us particularly immune from persistent inflationary forces. When that view was shattered by the reality of the late 1970s, bond markets collapsed. Much progress has been made in restoring the degree of confidence that existed earlier in the post World War II period, but it has taken years. Moreover, judging from the remaining inflation premium embodied in long-term rates, the job is not yet complete. Having paid so large a price in

reversing inflation processes to date, it is crucial that we do not allow them to re-emerge

Mr Chairman, with respect to your question about the so-called "natural rate" of unemployment, some analysts have suggested that unemployment relative to its natural rate can be used as a means of quantifying the aggregate demand-aggregate supply balance. The "natural rate" is usually defined as the rate of unemployment consistent with no tendency for the inflation rate to move up or down over time. Any attempt by either monetary or fiscal policy to hold the unemployment rate permanently below the "natural" rate, it is argued, would require increasing amounts of monetary accommodation that, in the end, would only succeed in pushing inflation continually upward. The record of the postwar period suggests that episodes of tightness in the labor market have been associated with increases in the rate of inflation, and the converse. But over the longer term, no trade-off is evident between inflation and unemployment.

While the idea of a national "threshold" at which short-term inflation rises or falls is statistically appealing, it is very difficult in practice to arrive at useful estimates that would identify such a natural rate. In large measure, these difficulties result from the enormous complexity and dynamism of our labor markets. Evolving demographic trends and changes in the geographical distribution of activity can alter the degree of short-term pressure on wages that is associated with any given measure of aggregate unemployment. Moreover, structural shifts in the pattern of demand across industries and occupations can also influence the so-called natural rate. In addition to the continual flux that is an integral element of our market economy, public policies--intentionally or

unintentionally--can raise or lower the natural rate depending on whether they hinder or facilitate adjustment in labor markets. Arriving at an overall assessment of these influences is far from straightforward and likely accounts for the wide range of estimates among professional economists. When the statistical uncertainty associated with these estimates is taken into account, a plausible "confidence interval" is likely even wider.

At present, assessments of the state of the labor market have been complicated by the revision this year to the Current Population Survey. Based on initial tests of the new questionnaire and collection techniques by the Bureau of Labor Statistics, it appeared that the changes likely would raise our statistical measure of the unemployment rate. In response, many analysts have increased their estimates of the natural rate by the presumed difference between the old and new surveys. But a variety of technical issues remain unresolved, and it may be a long time before we know with any certainty the influence of these changes on the measured unemployment rate.

In light of these uncertainties, I do not think that any one estimate of the natural rate is useful in the formulation of monetary policy. We clearly have entered a period in which economic policymakers need to watch carefully for signs of resource pressures in the labor market. But, appropriate analysis of current and prospective conditions will need to extend beyond the aggregate figures for the labor market alone and address regional and skill differences as they apply to wage determination.

Mr. Chairman, in addition to labor, the answers to your questions about our capacity for noninflationary growth will depend on

the expansion of the nation's stock of plant and equipment and, most importantly, ideas. Investment spending not only raises the amount of capital per worker--an essential determinant of labor productivity--but also is a principal channel through which new technologies are introduced into the production process. Today, we are in the midst of a capital spending boom, as companies strive to modernize existing plants and add capacity. Investment in computers and high-tech communications equipment has been particularly strong, stimulated by waves of technological improvement and rapidly expanding opportunities for the application of these technologies. But demand for more traditional types of industrial machinery also has been strong, and the construction of new production facilities has revived. This strength in capital spending has been driven by the relatively low level of financing costs and by the conviction within the business community that, with favorable prospects for a steady expansion of the economy, the risks in adding capacity are acceptable.

The Federal Reserve's own index of output capacity in manufacturing increased 2-1/4 percent last year and is likely to surpass that performance in 1994. The Federal Reserve's indexes define capacity as the highest level of output that a plant can maintain within the framework of a realistic work schedule, that is, one that allows for normal downtime and sufficient availability of inputs. The Fed capacity estimates are developed from a variety of sources, including capacity measures in physical units compiled by trade associations, as well as surveys of utilization rates as perceived by individual companies.

But businesses have the ability over time to respond to changing market conditions. When demand is picking up, firms

historically have been able to "stretch" capacity by working their capital and labor overtime. The ability to import raw materials, components, or even final products from assembly plants abroad, also can help at times to meet unexpected growth in demand. However, this is unlikely to be a permanent solution because increased demand pressures abroad as global activity recovers and expands will tend over time to push up import prices and eliminate any temporary cost advantage. At this point, we have little aggregate evidence that the increased openness of the U S economy over the past several decades has substantially altered the process of domestic price formation.

The rate of capacity utilization in manufacturing--a measure of the pressure on the domestic production of goods--was a shade under 83 percent in May--well above its historical average. However, as with the unemployment rate, there is no clear-cut "trigger point" for capacity utilization as a signal for emerging inflationary pressures. To be sure, as capacity utilization increases, bottlenecks occur with greater frequency, and production costs rise. Indeed, the recent firming of prices of some products and raw materials suggests that we may already be witnessing some elements of this process. To date, however, owing to constrained increases in unit labor costs, broad measures of producer prices for final goods have not generally reflected the increases in those input costs. In addition, monetary and credit growth remains quite muted. But, further increases in pressure on manufacturing facilities might suggest a greater risk of emerging inflationary imbalances.

Of course, aggregate price trends obscure considerable diversity across industries in the relationship of capacity utilization to prices. For example, operating rates are high in the

motor vehicle and computer-related industries. Yet the prices of light trucks have risen, while the prices of microprocessors have plunged. Such differences make it very difficult at the aggregate level to pin down a particular level of capacity utilization that can be associated with the emergence of inflation pressures. All told, the rate of capacity utilization in manufacturing is not a fool-proof measure of inflation pressures. But, like the unemployment rate, its level and trajectory deserve close attention.

The efficiency with which our labor and capital resources are combined also has an important influence on the aggregate supply potential of the economy, and the recent record here is cause for some optimism. Since the last business cycle peak in the summer of 1990, labor productivity--output per hour in the nonfarm business sector--has increased, on average, at about a 2 percent annual rate. At this stage, disentangling trend from cycle remains difficult. But there are some signs of improvement in our underlying productivity performance in response to increased global and domestic competition and improved management. In addition, the investment in high-tech equipment now finally appears to be paying off. It has taken businesses time to learn how to use computers effectively in their operations. But better hardware and significant advances in software now are permitting many companies to "re-engineer" the way they produce and distribute goods and services.

It is important to remember that growth in productivity is the key to increases in our standard of living over time. Productivity is the essential element that allows wages to grow in a noninflationary way. It is for this reason that over long periods of time broad measures of compensation per hour, which include both wages

and benefits, closely track the trend in labor productivity, when compensation is measured relative to the prices of the goods and services produced in the U S economy. Thus, if maintained, the strong growth in labor productivity in this expansion will be a very welcome development indeed

Finally, it is germane to ask what economic policymakers can do to foster faster growth of aggregate supply and thereby raise the threshold of resource utilization. In this regard, the role of monetary policy is rather narrow, but potentially potent. Most importantly we can reinforce ongoing trends in the private sector that enhance our productive potential by helping to create a stable environment for sustainable noninflationary economic growth. Stability in economic conditions boosts confidence and makes long-range planning by businesses and households much easier. In that regard, the maintenance of inflation sufficiently low that it need not be a factor in business and consumer decisionmaking enhances the operation of the market price mechanism and helps to ensure that resources are used most productively. Inflation interferes with such price signals and spawns the wasteful use of resources to hedge against unexpected price changes. Experience both here and abroad suggests that lower levels of inflation are conducive to the achievement of greater productivity and efficiency and, therefore, higher standards of living. In fact, there is some, but by no means definitive, evidence that lower rates of inflation have been associated not just with higher levels of productivity, but with faster growth of productivity as well. Owing to the increasing evidence of the deleterious effects of inflation, in recent years there has emerged a growing consensus throughout the world that a

monetary policy geared towards the pursuit of price stability over time is the central bank's most significant contribution to achieving maximal growth of a nation's well being

The actions undertaken by Congress also can have profound effects on the inflation threshold of our economy and its productive potential. Clearly, we ought to be encouraging measures to increase the flexibility of our workforce and labor markets. Improving education and facilitating better and more rapid matching of workers with jobs are essential elements in making more effective use of the U S labor force. Just as important, Congress should avoid enacting policies that create impediments to the efficient movement of individuals across regions, industries, and occupations, or that unduly discourage the hiring of those seeking work. Competitive markets have shown a remarkable ability to create rising standards of living when left free to function.

Finally, the Congress and the Administration can continue to contribute to the growth of our economy by the maintenance of a disciplined fiscal policy. Last year's budget agreement, especially the spending caps, was a significant step in putting fiscal policy on a more sustainable long-run path. But, as this Committee fully understands, under current policy and law, later in this decade federal outlays will almost surely again be rising at a pace that will exceed the growth of our tax base. Unless addressed, these trends will lead to increases in the deficit as a percent of GDP, with unacceptable consequences for financial stability and economic growth. As I indicated to this Committee last year, increases in tax rates cannot solve this problem. Only by reducing the growth in spending is ultimate balance achievable.

In summary, despite these considerable policy challenges and the always present future uncertainties, the outlook for the U S economy is as bright as it has been in decades. Economic activity has strengthened, unemployment is down, and price trends have remained subdued. In addition, unlike some earlier periods, business spending on new plant and equipment has been an important contributor to growth. This strength in investment will enhance economic efficiency and lay the foundation for the productivity gains that will bolster the economic welfare of our nation. The Federal Reserve welcomes these developments because the intent of our monetary policy in recent years has been to foster precisely this kind of healthy economic performance.