

For release on delivery  
10 00 a m , E S T  
December 7, 1994

Testimony by

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before the

Joint Economic Committee

United States Congress

December 7, 1994

I appreciate the opportunity to appear before you today to discuss current economic conditions and monetary policy developments

The impressive performance of the American economy continues. Real gross domestic product has grown more than 4 percent over the past year, and although price increases have picked up at earlier stages of processing, inflation at the consumer level remained below 3 percent over the twelve months through October.

In the early stages of the economic recovery, employment growth lagged behind the upturn in activity, raising concerns about the job-creating potential of our economy. But these concerns have been assuaged by the performance of our labor markets over the past two years. During this period, several million jobs have been added to nonfarm payrolls, and the unemployment rate has dropped sharply, to its lowest level since the summer of 1990.

A driving force in the greater-than-expected economic strength in recent quarters has been inventory investment. The growth in inventory levels has appreciably lagged the growth in sales in recent years, as just-in-time inventory programs have progressively lowered the levels of stocks required to insure coordinated production schedules. Moreover, improvements in transportation scheduling and telecommunications have allowed both foreign and domestic suppliers to fill orders from U.S. firms more quickly.

But there is obviously a limit to how tight goods-flow schedules can be pressed and how slim inventory-sales ratios can become, without jeopardizing required production levels to meet customer orders. Judging from evidence of lagging product deliveries, that limit appears to have been reached last spring, at least for this business cycle.

So long as sales growth was holding up, which it has done, this meant that with inventory-sales ratios no longer falling the growth in inventory levels had to accelerate from its path of recent years. Implied, of course, has been a sharp pickup in inventory investment, and a corresponding boost to overall output and incomes. This process in turn has added to the strong growth in consumer expenditures and the consequent pickup in business cash flow, which has been a potent force in the expansion of plant and equipment outlays.

Had the inventory accumulations of recent quarters been the result of unexpected weakness in sales, and hence unintentional, we would have expected a widespread falloff in new industrial orders. As yet there is no evidence to suggest that. Moreover, while inventory investment has been substantial since the spring, a greater-than-usual proportion reflects the value added of goods that have moved further down the distribution chain. Thus, while large increases in the constant dollar value of inventory investment have added to GDP, the buildup in physical units, or the factory value of inventories, is still modest relative to sales. It is excessive units of physical inventories that depress production irrespective of where in the distribution pipeline they reside. Of course, a sudden weakening in final demand could make existing levels of inventories, wherever they are, look excessive fairly quickly, so we cannot be complacent that the current economic expansion is without risk.

But we should also keep in mind that to the extent that retail and wholesale trade inventories are dominant elements in the overall inventory expansion, changes in inventory investment will not fall solely on domestic production and employment. This is because, as America's appetite for foreign products rises, a commensurately

larger proportion of inventories is imported. Rough estimates suggest that, currently, perhaps a quarter of all wholesale and retail stocks are imported, whereas as recently as the late 1970s the share was substantially less. As a result, swings in final demands and accompanying changes in desired inventories now fall to a larger extent than in the past on foreign producers.

When all is said and done, stocks appear lean relative to final demand right now, despite several quarters of significant accumulation. Nonetheless, intended inventory investment cannot be expected to rise appreciably from current levels, and eventually will have to fall to a level more consistent with sustainable growth in final demand. Thus, the degree of strength in final sales will be central to the support of future gains in output.

Over the past two years, business fixed investment, particularly in producers' durable equipment, has made an important contribution to the growth in final sales. The growth rate of spending on computers has fallen off this year from last year's phenomenal pace, but outlays have, nonetheless, continued to advance at a double-digit rate in real terms as the computerization of the American economy proceeds apace. Business spending on motor vehicles, particularly heavy trucks, has been strong this year, while spending on other equipment, especially in the communications area, has accelerated from last year's already quite rapid growth rate. Recent data on orders for capital goods suggest that above average growth in equipment spending will likely continue.

In the nonresidential structures area, construction has begun to increase again after several years of decline. Even in the office building sector, where construction fell by about one-half between 1989 and 1993, activity has begun to recover. Construction would have

been even weaker in the early 1990s had it not been for the completion of a large backlog of unfinished projects that had built up during the 1980s. The backlog of projects in the office sector fell steadily from 1989 to 1993 but recently has stabilized, so that the pickup in construction this year has been fueled by a recovery in starts of new projects. Recent nonresidential construction contracts and permits suggest further gains in outlays.

Support for capital outlays during the past year has come from the extraordinary rise in corporate profits. During the first three quarters of 1994 profits were 14 percent higher than in the first three quarters of 1993. Moreover, profits continue to come in ahead of expectations, a factor that has been spurring business confidence and capital commitments.

Turning to the residential sector, housing starts remained robust in the third quarter, but edged off a bit in October. Construction of single-family homes has held at a fairly high level, and multifamily activity, although still at a low level, has begun to recover. Solid income growth, the improved labor market, and buoyant consumer confidence have been important factors boosting demand for houses this year. In addition, residential construction has also likely been supported by some easing in the standards that mortgage lenders use in qualifying prospective homebuyers. In particular, lenders have been increasingly willing to accept mortgages with low down payments. In fact, according to a survey by the Federal Housing Finance Board, one-third of loans recently have had down payments of less than 10 percent. Also, some of the damping effect of higher rates on fixed-rate mortgages has been attenuated by a sharp rise in the market share of adjustable-rate mortgages. Lenders have been

making these adjustable-rate loans more attractive by keeping first-year loan rates low relative to market interest rates and by extending the period before annual adjustments occur, often for as long as five or ten years

The healthy growth of real income that I noted earlier has also been an important factor behind the strength in consumer spending. Outlays for consumer durable goods have been quite robust this year, and spending on nondurables and services has picked up from last year. Much of the growth in consumer durables this year has been spending on computers and other electronic goods, which has been especially strong. Purchases of motor vehicles have remained buoyant after climbing in 1993 to the highest level in four years.

Exports of goods and services have also been an important source of economic growth this year, with real gains over the past four quarters averaging more than 10 percent at an annual rate. U.S. exporters have benefited from an increase in demand associated with the pickup in economic activity abroad. The economic recoveries that began in 1992 in Canada and the United Kingdom gained momentum in the past year and the more tentative recoveries in the continental European countries and Japan appear to be gaining a firmer footing. Much the same can be said for Mexico. Meanwhile, rapid growth in other developing countries that are major U.S. trading partners has continued. These developments should help undergird growth in exports from the United States in the near term. Nevertheless, imports recently have been growing even faster than exports. Consequently, the external sector has made a negative contribution to GDP growth, though less than in 1993.

One sector in which spending has been on a downtrend in recent years is the federal government, especially in the defense

area The decline in defense spending was interrupted in the third quarter, however, by the first increase in real defense purchases in two years This uptick was partially attributable to outlays for the invasion of Haiti and the detention of Cuban refugees Defense purchases of durables were strong as well, stemming in part from the delivery of two B2 "stealth" bombers in August However, these short-term developments will not alter the longer-term declines in defense spending embodied in current budgetary plans

Adding all sectors together, growth in gross domestic product this year is running somewhat stronger than we had anticipated earlier in the year Spending in 1994 has been encouraged by the greater willingness of banks and other lenders to extend credit following a protracted period of bank lending restraint that was characterized as the "credit crunch " I have already noted the possibility that more generous and flexible loan terms have supported the housing market But easier loan terms and conditions are more widespread In effect, not all of the rise in short- and intermediate-term market interest rates is being passed through to bank borrowers Spreads of bank loan rates over market rates have narrowed for many business and household borrowers, other fees have been cut, and standards for approving loans have been eased This is a trend we are monitoring carefully, not only in our role as monetary policymakers, but also as bank supervisors with responsibility for the safety and soundness of the banking system

As the repressive pall of the balance sheet strain of the early 1990s dissipated, and employment and production picked up, households and businesses have gained greater confidence This increased optimism has manifested itself in a number of reinforcing ways It has motivated households to increase their borrowing and

spending, which has inspired businesses to invest more and to hire workers in anticipation of future sales growth. Of course, increased hiring in turn helps assuage the concerns of households about employment prospects, contributing to gains in household confidence. Indeed, as measured by one survey, consumer confidence moved up to a new high for this expansion in November.

Despite strong output and employment growth this year, consumer price inflation--at a 2.6 percent annual rate so far this year through October--has been running at about the same pace as through all of 1993. Excluding the food and energy components, which are volatile, consumer prices have increased 2.8 percent through October, somewhat less than in 1993 as a whole.

Although inflation at the consumer level has been flat or down somewhat compared with last year, prices of intermediate supplies have accelerated. This pickup in turn reflects pressures from prices of raw commodities, which have been rising rapidly for nearly two years, as well as high and rising levels of capacity utilization. So far, increases in manufacturers' prices at the finished goods level have remained contained. To date, modest increases in labor compensation coupled with rapid growth in labor productivity have suppressed increases in unit labor costs and helped alleviate the pressures of higher input costs on final prices. However, with demand for their output strong, finished goods producers may soon attempt to pass on their higher costs.

Some have argued that businesses will not be successful in raising prices--that the competitive environment has changed in such a way that the economy can grow on a sustained basis much faster and operate at substantially higher levels of resource utilization than in the past. These analysts often cite the improving productivity of



U S businesses and the more intense pressure from actual or potential foreign sources of goods and services They also note that the pressures of changing technology and corporate downsizing may be increasing labor insecurity and damping wage demands

There is a significant element of truth in these arguments But these developments are evolutionary, working slowly and incrementally over time The pickup in trend productivity growth is probably no more than a few tenths of a percentage point annually Unemployment rates have fallen and the slowing of product delivery schedules underscores that capacity utilization rates have risen substantially, if the productivity trend had moved sharply higher, we could have achieved higher output growth without these developments Moreover, the increase in international trade is a gradual process that has been going on for several decades And the weakness of the dollar on foreign-exchange markets on average this year has tended to undercut any cost-containment pressures from this source in the near term

We recognize that estimates of the economy's potential are just that--estimates, subject to the considerable uncertainties attached to all economic estimates In setting monetary policy, the Federal Reserve is looking to encourage the highest level of activity that the economy can sustain, not to hold it back We would welcome the possibility that our economic performance can be in excess of historical relationships

But if we ignore experience, we would be taking unacceptable risks of higher inflation, economic and financial instability, and ultimately subpar economic performance over time We must remain alert to signs of inflationary pressures on resources If we allow these to develop, resources will begin to be used less efficiently,

productivity improvements will be harder to find, and firms will be more disposed to raise prices

If price increases are accommodated, they can become readily embedded in higher inflation expectations. It is these expectations that make an inflationary process, once begun, difficult and expensive to reverse. As people begin to expect higher inflation, their actions to protect the purchasing power of their wages and profits add to the impetus toward accelerating prices. Experience suggests that these expectations can be turned around only slowly and with some cost to the economy's performance.

We have been especially concerned about the possibility that in the current circumstances, inflation expectations could be particularly prone to adjust upward if actual inflation were to pick up. As best we can infer from surveys and financial markets, inflation is expected to be higher in the future than it has been in the recent past. This suggests some nervousness about the resolve of anti-inflation policies. Indeed, with inflation at the lower end of its range over the past thirty years, it would be natural for many, if not most, workers, businesses, and financial people to be quick to see reasons for inflation to return to the higher levels that dominate their experience. An inclination toward higher expected inflation would be reinforced by the tendency in the past for actual inflation to pick up at some point in a business expansion.

The potential for higher inflation has had an important influence on the behavior of financial markets this year. Prices in those markets seem to incorporate significant further increases in real short-term interest rates but, nonetheless, also appear to suggest that inflation will move higher.

While there is doubtless a good deal of uninformed opinion driving market prices up and down in the short run, we cannot ignore broad movements in these markets, for they may be telling us something about deep-seated changes in expectations. The prices set in financial markets represent the views of a large and diverse group of participants worldwide. The trading professionals in bond, equity, and foreign exchange markets can move prices around for a brief time. But, since their securities holdings are a small share of overall markets, after a period of a few days or weeks, the actions of other major participants become dominant. These include corporate and state and local government treasurers deciding on the best time to raise funds, and, on the other side of the market, experienced managers both here and abroad of the large sums of dollar-denominated securities in pension funds, insurance companies, and university endowments. Moreover, millions of Americans have taken a more direct role in financial markets through their purchases of mutual funds. Indeed, more than half of the net capital market securities issued in the U S since the end of 1992 were absorbed by mutual funds. Transactions in these funds are driven by sales to Main Street America.

To forestall a new round of higher inflation and inflation expectations, the Federal Reserve began to adjust policy earlier this year in advance of an actual acceleration in broad measures of prices. Monetary policy works with considerable lags and waiting until inflation picks up risks a boom-and-bust economic cycle inimical to business and household planning, to saving and investment, and to the longer-term growth of the U S economy. As I indicated to the Congress in testimony earlier this year, the hallmark of a successful monetary policy will be an inflation rate that does not rise

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