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Testimony by

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Board of Governors of the Federal Reserve System

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Mr Chairman, members of the Committee, I am pleased to be able to appear here today, to offer my thoughts on the economic backdrop for your policy discussions

The U S economy has recorded some notable achievements over the past few years, but there is nonetheless much left to be accomplished The fiscal decisions made by the Congress in the next several months will play a critical role in determining the economic welfare of our citizens over the years--indeed, the decades--to come

I perhaps should begin with a brief review of the current condition of the economy There is no question that the past year was one of remarkable progress along many dimensions of macroeconomic performance The official estimates for the fourth quarter are not yet available, but it is clear that real gross domestic product expanded by about four percent over the course of 1994--the best gain in some time, and one that surpassed most expectations Importantly we saw an accelerated expansion of employment as well Cumulatively, payrolls have now increased roughly 6 million over the past couple of years, belying in dramatic fashion the notion that had developed earlier in this decade that our economy had lost its job-generating ability With the rapid growth of employment, the national unemployment rate has fallen sharply, to less than 5-1/2 percent this past month

The economic gains have been broad They have encompassed almost all major segments of industry and all parts of the country The expansion in recent quarters has been paced by growth of business investment and exports, and as a consequence, we have seen not only a continuation of robust increases in service sector employment but also a significant upturn in job creation in the manufacturing sector Manufacturing output increased 6 8 percent last year, and measured factory employment rose almost 300,000 I say "measured" because it has been true for some time now that manufacturers have relied to an increasing degree on workers supplied by temporary help firms, which are recorded separately in the service industry But it is clear that last year saw a significant gain in the overall factory workforce Moreover, I would note the reports in the recent "Beige Book" survey assembled by our regional Reserve Banks that manufacturers now are expressing a greater inclination to add workers directly to their payrolls This is a sign of the greater confidence that firms now have that future levels of activity will remain high

Geographically, contractions in some sectors such as defense and finance have left their negative imprint on certain locales, but rising activity and improving job opportunities have characterized most areas of the country Notably, California--accounting for roughly an eighth of the nation's economy--appears to be in the process of turning around Unemployment rates have fallen in all regions, and are lower in most now than they were at the peak of the last business cycle expansion Moreover, the gains in employment have benefited all major demographic segments of the labor force as well

Of crucial importance to the sustainability of these gains, they have been achieved without a deterioration in the overall inflation rate The Consumer Price Index rose 2 7 percent last year, the same as in 1993 Inflation at the retail level, as measured by the CPI, has been a bit less than 3 percent for three years running now--the first time that has occurred since the early 1960s This is a signal accomplishment, for it marks a move toward a more stable economic environment in which households, businesses, and governmental units can plan with greater confidence and operate with greater efficiency When we consider the probable upward bias of the CPI, it would appear that we have gotten close to achieving effective price stability, though we're not there yet

In 1994 we had a difficult reversal in monetary policy to navigate The overhang of debt and the strains that emerged among our financial intermediaries, especially out of the commercial real estate collapse of the late 1980s, required a heavy dose of monetary ease beginning in 1989 to alleviate a significant credit crunch The danger of overstaying that policy of ease was clear, particularly as we moved through 1993, but the right time to change course was difficult to determine Judging from the developments of the past year, it appears that our policy reversal last February was timely--but we won't know for sure except in retrospect

As I have stated many times in Congressional testimony, I believe firmly that a key ingredient in achieving the highest possible levels of productivity, real incomes, and living standards is the achievement of price stability Thus, I see it as crucial that we extend the recent trend of low and hopefully declining inflation in the years ahead The prospects in this regard are fundamentally good but there are reasons for some concern, at least with respect to the nearer term Those concerns relate primarily to the fact that resource utilization rates already have risen to high levels by recent historical standards The current unemployment rate, for example, is comparable to the average of the late 1980s, when wages and prices accelerated appreciably The same is true of the capacity utilization rate in the industrial sector

Clearly, one factor in judging the inflationary risks in the economy is the potential for expansion of our productive capacity If "potential GDP" is growing rapidly, actual output can also continue to grow rapidly without intensifying pressures on resources In this regard, many commentators, myself included, have remarked that there is something of a more-than-cyclical character to the evident improvement of America's competitive capabilities in recent years Our dominance in computer software, for example, has moved us back to a position of clear leadership in advanced technology after some faltering in the 1970s But, while most analysts have increased their estimates of America's long-term productivity growth, it is still too soon to judge whether that improvement is a few tenths of a percentage point annually, or even more, perhaps moving us much closer to the more vibrant pace that characterized the early post-World War II period It is fair to note, however, that the fact that labor and factory utilization rates have risen as much as they have in the past year or so does argue that the rate of increase in potential is appreciably below the 4 percent growth rate of 1994

Knowing in advance our true growth potential obviously would be useful in setting policy, because history tells us that economies that strain labor force and capital stock limits tend to engender inflationary instabilities which undermine growth Moreover, in such an environment asset prices can begin to rise unsustainably, contributing to an unstable financial and economic environment It is true, however, that in modern economies output levels may not be so rigidly constrained in the short run as they used to be when large segments of output were governed by facilities such as the old open hearth steel furnaces that had rated capacities that could not be exceeded for long without breakdown Rather, the appropriate analogy is a flexible ceiling that can be stretched when pressed, but, as the degree of pressure increases, the extent of flexibility diminishes It is possible for the economy to exceed "potential" for a time without adverse consequences by extending workhours, by deferring maintenance, and by forgoing longer-term projects Moreover, as world trade expands, access to foreign sources of supply augments to a degree the flexibility of domestic productive facilities for goods and some services

Aggregative indicators, such as the unemployment rate and capacity utilization, may be suggestive of emerging inflation and asset price instability problems But, they cannot be determinative History shows clearly that given levels of resource utilization can be associated with a wide range of inflation rates Accordingly, policymakers must monitor developments on an ongoing basis to gauge when economic potential actually is beginning to become strained--irrespective of where current unemployment rates or capacity utilization rates may lie If we are endeavoring to fend off instability before it becomes debilitating to economic growth, direct evidence of the emerging process is essential Consequently, one must look beyond broad indicators to gauge the inflationary tendencies in the economy

In this context, aggregate measures of pressure in labor and product markets do seem to be validated by finer statistical and anecdotal indications of tensions In the manufacturing sector, for example, purchasing managers report slower supplier deliveries and increasing shortages of materials Indeed, firms appear to have been building their inventories of materials in recent months so as to ensure that they will have adequate supplies on hand to meet their production schedules These pressures have been mirrored in a sharp rise over the past year in the prices of raw materials and intermediate components There are increasing reports that firms are considering marking up the prices of final goods to offset those increased costs In the labor market anecdotal reports of "shortages" of workers have become more common--as indicated, for example, in our Beige Book last week--and there are vague signs of upward pressures on wages To be sure, increased wages are a good thing if they can be achieved without commensurate acceleration in prices, but they are not beneficial if they are merely a part of a general pickup in inflation A hopeful sign in this regard, however, is that to date the trends in money and credit expansion have remained subdued They do not suggest that what I've referred to elsewhere as the "financial tinder" needed to support on ongoing inflation process is in place

That kind of ongoing process also would be expected to involve a different expectational climate than seems to prevail today Despite the marked improvement in consumer confidence overall, the survey readings on consumers' views of whether jobs are easy to get fall far short of the previous cyclical peak in 1989 Moreover, there is evidence that the number of people voluntarily leaving their jobs is subnormal currently This suggests that the deep-seated fear of job insecurity has not fully dissipated despite ample evidence of strong job growth recently

Some analysts attribute this phenomenon to workers' concerns about losing health insurance and, for some, pension coverage if they change jobs Whatever the cause, the lingering sense of insecurity doubtless has been a factor damping wage growth and overall labor costs Since the latter on a consolidated basis, account for roughly two-thirds of overall costs in our economy, slower wage growth combined with strong cyclical productivity growth has restrained increases in unit labor costs and hence in prices of final goods and services

However, as overall output growth of necessity slows in an environment of high resource utilization so will cyclical productivity growth Moreover, if labor market tightness assuages fears of job insecurity, pressures to raise wages will intensify and unit labor costs could accelerate In the later stages of previous business cycles, profit margins were squeezed, but some of the underlying unit labor cost increases were nonetheless passed through into final goods prices and inflation picked up Thus far in the current cycle, any tendency toward the emergence of this kind of process has been muted by a prevailing concern among firms that, despite capacity pressures, enough slack and subdued unit costs remain in the system to foster competitive inroads on those who try to price above the market But this form of discipline may also become less effective as pressures on resources persist Consequently, it may be that these pressures will lead to some deterioration in the price picture in the near term, but any such deterioration should be contained if the Federal Reserve remains vigilant

The actions of the Congress and the Administration in the fiscal sphere will also be important in maintaining public confidence that inflation will be subdued There can be no doubt that the persistence of large federal budget deficits represents in the minds of many individuals a potential risk While we clearly have avoided it in recent years, history is replete with examples of fiscal pressures leading to monetary excesses and then to greater inflation Currently, I strongly suspect that investors here and abroad are exacting from issuers of dollar-denominated debt an extra inflation risk premium that reflects not their estimate of the most likely rate of price level increase over the life of the obligation, but the possibility that it could prove to be significantly greater This inflation risk premium is costly, because it raises the hurdle that must be surpassed when looking at the expected returns on possible investment projects

But the influence of the fiscal imbalance of the federal government on capital formation is broader than that The federal deficit drains off a large share of a regrettably small pool of domestic private saving, thus contributing further--and perhaps to an even greater degree--to the elevation of real rates of interest in the economy Admittedly, there is some uncertainty about the causes of what seem to be relatively high real long-term rates around the world, as was noted by leaders of the largest industrial nations at their summit meeting last year But the vast majority of analysts would agree that in the United States the current sizable federal deficits, and the projected growth of those deficits over the decades ahead, are a significant element in the story

In sum, the recent performance of the macroeconomy has been encouraging But much of the improvement is in the nature of cyclical developments and we all have our work cut out for us if we are to extend these gains and foster long-term trends that enhance the welfare of all of our citizens The central role of the Federal Reserve today is to ensure that our economy remains on a sustainable, noninflationary path For the Congress, a crucial focus should be continuing the process of fiscal consolidation and rectifying the secular shortfall in domestic saving that is limiting the growth of our nation's productive potential