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Testimony by

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before the

Committee on the Budget

U S House of Representatives

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Mr Chairman and other members of the Committee, I appreciate this opportunity to discuss the Federal Reserve's conduct of monetary policy. Because I presented our semiannual Monetary Policy Report to the Congress just two weeks ago, I will review only briefly the current outlook before focussing on some key longer-term issues bearing on macroeconomic policy, issues that are highly relevant to recent foreign exchange market developments.

The weakness of the dollar against other major currencies is both unwelcome and troublesome. Dollar weakness, while very likely overdone, is unwelcome because it adds to potential inflation pressures in our economy. As I have emphasized numerous times in the past, it is important that we contain such pressures.

Dollar weakness is also troublesome because it is doubtless symptomatic of some of the underlying problems confronting the longer-term health of the economy: inadequate national savings, continuing large budget deficits, and a persistent current account imbalance.

#### The Current Outlook

Turning to the economic outlook, the data that have been published thus far in 1995 have offered some indications that the expansion may be slowing from its torrid and unsustainable pace of late 1994. While hours of work lengthened in January, employment growth slowed from its average of recent quarters and the unemployment rate rose. Moreover, recent readings on retail sales suggest a more moderate rate of increase, and housing activity has shown some softness. Nonetheless, to date, the real economy appears to have continued to grow, without seeming to develop the types of imbalances that in the past have undermined ongoing expansions.

The degree of the strength of the expansion this year is likely to depend on the same elements that contributed strongly to

last year's solid performance plant and equipment outlays and inventory investment Although the recent newly revised survey of plant and equipment investment intentions of American business points to more modest increases in capital spending than were reported for last year, there are, as yet, few indications of that degree of slowing in orders for nondefense capital goods or in contracts or permits for private nonresidential building Indeed, backlogs of equipment orders are rising relative to sales, and business profitability, a key factor in investment plans, continues to exceed expectations The investment plans of manufacturers, whose capacity is clearly stretched, reflect this strong demand for capital goods But planned spending outside of manufacturing, especially among utilities and service industries, is evidently softening Of course, at this stage, the lack of an historical track record for this new Department of Commerce survey makes it very difficult to draw firm conclusions from these figures

Inventory investment contributed the better part of a percentage point to overall economic growth last year, and, while that type of boost to growth this year seems most unlikely, there is little evidence that an overhang has developed that will lead to an abrupt adjustment of production any time soon Standard inventory-sales ratios remain on the low side of historical experience, those ratios look even lower compared with historical experience if one subtracts wholesale and retail markups from the published inventory investment figures to get a better handle on the underlying physical units of stocks Moreover, even if there were a swing in inventory investment, it would have a more muted effect on domestic production than the inventory cycles of just a few years ago Rough estimates suggest that, currently, perhaps a quarter of the nominal value of all

wholesale and retail stocks are imported, whereas the share was markedly less as recently as the late 1970s

As I indicated in my recent testimony, while there are signs that spending is slowing, the jury remains out on whether that will be sufficient to contain inflation pressures. We must remember that the nation has entered 1995 with its resources stretched. If we are to do our part in helping the economy operate at its fullest potential over time, we need to remain watchful to ensure that any upswing in the inflation rate does not become firmly entrenched.

#### Gauging Inflation Risks

I remain firmly of the belief that a key ingredient in achieving the highest possible levels of productivity, real incomes, and living standards over the long run is the achievement of price stability. Thus, I see it as crucial that we extend the period of low inflation, hopefully returning it to a downward trend 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. These concerns relate primarily to the fact that resource utilization rates have already risen to high levels by recent historical standards.

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 might well be more than a cyclical character to the evident improvement of America's competitive capabilities in recent years. But it is still too soon to judge whether that improvement is a few tenths of a percentage point annually, or even more. 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 inflation instabilities that undermine growth. 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. 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 improvements. 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 instabilities. But, they cannot be determinative. Policy makers 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. The Federal Reserve will remain watchful to these developments, while remaining focussed on its longer-run goal--the eventual achievement of price stability. We can do no less if we are to maximize our opportunity for advancing the economic well-being of the nation.

### Fiscal Policy

We must recognize that the productive potential of the U S economy will be shaped significantly by the actions of this Congress regarding the federal budget deficit. Too much of the small pool of national saving goes toward funding the government. In the past few years, we as a nation have been able to finance our investment by tapping saving from abroad. The United States has been running persistent and growing deficits in its current account position vis-a-vis the rest of the world. This ability to finance our domestic investment from abroad highlights the openness of world capital markets. But it would certainly be unwise and probably impossible to rely on them forever. Indeed, given the recent weakness in the foreign exchange value of the dollar, world capital markets may be sending us just that message. This suggests that a key element in dealing with the dollar's weakness is to address our underlying fiscal imbalance convincingly.

If we are to sustain the higher levels of investment that are crucial to achieve healthy increases in productivity and to remain a viable competitor on world markets, we must raise the level of domestic saving and reduce our reliance on foreign saving. Reliable and robust estimates of the determinants of private saving have eluded economists for many years, we can only conclude that there is no sure-fire scheme that this Congress could adopt to entice our citizens to save more. But the government can decide to use less of private domestic saving than it does now. By trimming the deficit, those resources will likely be put to more productive uses, leading to benefits in the form of improved standards of living.

Trimming the deficit would doubtless make the economy more vibrant and less reliant on foreign sources of capital over time. But

there would be shorter-run benefits as well. While there is some uncertainty about the causes of the apparent relatively high real long-term rates around the world, the majority of analysts would agree that, in the United States, the current sizable federal deficits--and their projected growth over the decades ahead--play a significant role. In part, this owes to market participants' perception of the risks to future monetary policy that are posed by persistent large federal budget deficits. While we at the Federal Reserve have clearly avoided it in recent years, world history is replete with examples of fiscal pressures leading to monetary excesses and then to greater inflation. Progress in addressing the federal deficit would do much to eliminate any lingering suspicion that the Federal Reserve would ultimately accommodate fiscal imbalances by monetary excess. This would help to lower inflation risk premiums that are embedded in dollar-denominated assets. All told, a credible program of fiscal restraint that moves the government's finances to a sounder footing almost surely will find a favorable reception in financial markets. That market reaction, by itself, should serve as a source of stimulus that would help to offset in whole or in part the drag on spending that otherwise would be associated with reductions in federal outlays and transfers over time.

#### Conclusion

I can assure the members of this Committee that we at the Federal Reserve share your goal--the largest possible advance in living standards in the United States over time. That goal can be best achieved if our actions ultimately allow concerns about the variability of the purchasing power of money to recede into the background. Price stability enables households and firms to have the greatest freedom possible to do what they do best--to produce, invest,

and consume efficiently. Moreover, a credible program of fiscal restraint will do much to free up private resources for more productive purposes.

Formidable challenges will confront policy--both fiscal and monetary--in the years ahead. It is, of course, unrealistic to assume that we can eliminate the business cycle, human nature being what it is. But containing inflation and thereby damping economic fluctuations is a reasonable goal. We at the Federal Reserve look forward to working with the Administration and the Congress in meeting our common challenges.