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Testimony by

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Chairman

Board of Governors of the Federal Reserve System

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Subcommittee on Domestic and International Monetary Policy

Committee on Banking and Financial Services

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Mr Chairman and members of the Subcommittee, I am pleased to appear today to present the Federal Reserve's semi-annual report on monetary policy. In February, when I was last here for this purpose, I reported that the U S economy had turned in a remarkable performance in 1994. Growth had been quite rapid, reaching a torrid pace by the final quarter of the year, when real GDP rose at a 5 percent annual rate and final sales increased at a 5-3/4 percent rate. Inflation had remained subdued through year-end, although productive resources were stretched. The unemployment rate had fallen to its lowest level in years, while manufacturing capacity utilization had been pushed up to a historically high level.

As I indicated in February, a slowing of economic growth to a more sustainable pace, with resource use settling in around its long-run potential, was required to avoid inflationary instabilities and the adverse consequences for economic activity that would invariably follow. After posting three straight years of consumer price increases of less than 3 percent for the first time in decades, inflation seemed poised to move upward. Reflecting market pressures, prices of raw materials and intermediate goods had already risen considerably, and a surge in the prices of a variety of imported goods could be expected to follow the weakening in the dollar through early 1995.

Monetary policy tightenings over the previous year had been designed to foster the type of moderation in final demand that would help damp inflation pressures going forward and sustain the economic expansion. When we began the policy tightening process, we knew the previous drags on the economy stemming from balance-sheet stresses and restraints on lending were largely behind us. But that still did not make it a simple matter to gauge just what degree of firming in reserve market conditions would be necessary to produce a financial environment consistent with sustainable economic growth. In the event, the federal funds rate was raised to 6 percent, as the surprising strength in the economy and associated pressures on resources required a degree of monetary policy restraint to ensure that inflation would be contained.

Fortunately, we started the tightening process early enough and advanced it far enough that monetary restraint began to bite before some potential problems could assume major proportions. With inadequate monetary restraint, aggregate demand could have significantly overshoot the economy's long-run supply potential and created serious inflationary instabilities. Moreover, the perceived capacity constraints and lengthening delivery times that come with an overheated economy could have fostered the development of more serious inventory over-accumulation. In such circumstances, the longer the moderation in output

growth is delayed, the larger will be the inventory overhang, and the more severe will be the subsequent production correction. As hoped, final sales slowed appreciably in the first quarter of this year, but inventory investment didn't match that slowing, and overall inventory-sales ratios increased slightly. Although the aggregate level of inventories remained modest, a few major industries, such as motor vehicles and home goods, found themselves with substantial excesses. Attempts to control inventory levels triggered cutbacks in orders and output that inevitably put a damper on employment and income.

How the ongoing pattern of inventory investment unfolds is a crucial element in the near-term outlook for the economy. Production adjustments could fairly quickly shut off unintended inventory accumulation without a prolonged period of slack output--one that could adversely affect personal incomes and business profitability, which in turn could undermine confidence and depress spending plans. Under these conditions, final sales should continue to grow through and beyond the inventory correction, leading to sustained moderate economic expansion. But a less favorable scenario certainly cannot be ruled out. The inventory adjustment could be extended and severe enough to drive down incomes, disrupt final demand, and set in motion a period of weak growth, or even a recession.

Useful insights into how an inventory correction is proceeding often can be gained by evaluating developments in industries that supply producers of final durable products with key primary inputs--such as steel, aluminum, and capital equipment components and parts. This is because inventory adjustments often are larger in durable goods and they become magnified at progressively earlier stages in the production process. Typically, when purchasing managers for durable-goods producing firms find their inventories at excessive levels, they reduce orders for materials and also for components of capital goods, and as a consequence suppliers shorten promised delivery times and cut back on production. In the current instance, domestic orders for steel and aluminum and for some capital equipment components have weakened, but not enough to have had more than modest effects on production. Prices of key inputs also suggest that demand so far is holding up and the inventory correction is contained. The price of steel scrap, for example, has not fallen, and spot prices of nonferrous metals on average have stabilized recently after considerable weakness in the first part of the year. Though still lethargic, the behavior of durable goods materials and supplies markets scarcely evidences the type of broader inventory liquidation that usually has been at the forefront of the major inventory recessions of the past.

At the finished goods level, we experienced significant inventory liquidation in both cars and trucks in May and June. We do not have comprehensive, up-to-date inventory evaluations for recent months as yet, but inferring what we can from scattered and partial data, the prospects seem reasonably good for a reduction in inventory investment that moves us a considerable way toward eliminating unwanted stocks.

That process and the longer run outlook for the economy depend ultimately on the behavior of final sales. In that regard, the slowing of the growth of final sales that began in the first quarter seems to have continued a little further in the second quarter. Combining final sales and the likely reduced second-quarter pace of inventory investment, the level of overall domestic production of final goods and services, or real GDP, evidently changed little last quarter.

Going forward, of the several credible outlooks, the most probable is for an upturn in the growth rate of final sales and real GDP over the rest of this year and a moderate pace of expansion next year with the economy operating in the neighborhood of its potential. One area of improvement should be our external sector. A significant downside risk when I testified in February related to the situation in Mexico. The economic contraction in that country and the depreciation of the peso did act to depress

our net exports in the first half of the year. But with the external adjustment of the Mexican economy apparently near completion, this drag should be largely behind us. Moreover, our trade with the rest of the world should begin to impart a positive impetus to our economic activity, partly because of the strong competitive position of U S goods in world markets.

Regarding domestic final demand, financial developments so far this year should provide important support over coming quarters. Interest rates, especially on intermediate- and long-term instruments, have fallen a great deal since last fall, in reaction to the improved fiscal outlook, the effects on inflation expectations of our earlier monetary tightening, and, of course, recently, the slowed economy. Lower interest rates have helped to buoy stock prices, which have soared ever higher. The positive implications of the rally in financial markets for household debt-service burdens and wealth and for the cost of capital to businesses augur well for spending on consumer durables, on housing, and on plant and equipment. These influences should be reinforced by the generally strong financial condition and the willingness to lend of depository institutions, as well as the receptiveness of capital markets to offerings of debt and equity.

Early signs of a little firming in consumer durables spending are already visible in the stabilization of

the motor vehicles sector. Residential construction also has started to revive, judging by the recent data on home sales and mortgage applications. Unfilled orders are sizable in the capital goods area, suggesting business investment in equipment will continue growing, albeit perhaps more slowly than in the recent past. Finally, rising permits suggest expansion in nonresidential construction.

An outlook embodying a resumption of moderate economic growth is conveyed by the central tendencies of the expectations of the Federal Reserve Governors and Reserve Bank Presidents for real GDP. After the second-quarter pause, a projected pickup in activity in the second half would put output growth over the four quarters of the year in the neighborhood of 1-1/2 to 2 percent. For next year, projections of real GDP growth center on 2-1/2 percent.

The inflation picture is less worrisome than when I testified six months ago, just after our last policy tightening. Demands on productive resources should press less heavily on available capacity in the future than we envisioned in February. This prospect is evident in the central tendency of the expectations of the Governors and Presidents for the unemployment rate in the fourth quarter of this year, which has been revised up from about 5-1/2 percent in February to 5-3/4 to 6-1/8 percent. This outlook for unemployment has been extended through next year as well. Increases in employment costs to date have been

modest, and labor compensation evinces few signs of exacerbating inflation pressures, although the recent unusually favorable behavior of benefit costs is unlikely to continue. Declines in industrial output over recent months have already eased factory utilization rates closer to their long-term averages. Reflecting a slowing in foreign industrial economies as well as in the United States, the earlier surge in prices of materials and supplies has tapered off. Moreover, the stability of the exchange value of the dollar in recent months bodes well for an abatement of the recent faster increase in import prices.

Against this background, most Governors and Presidents see lower inflation over coming quarters than experienced in earlier months of 1995. The central tendency for this year's four-quarter rise in the CPI is 3-1/8 to 3-3/8 percent. And for next year, the central tendency suggests that CPI inflation will be shaved to 2-7/8 to 3-1/4 percent.

The success of our previous policy tightenings in damping prospective inflation pressures set the stage for our recent modest policy easing. Because the risks of inflation apparently have receded, the previous degree of restriction in policy no longer seemed needed, and we were able at the last meeting of the Federal Open Market Committee (FOMC) to reduce the federal funds rate by 1/4 percentage point to around 5-3/4 percent.

Indeed, inflation pressures were damped somewhat more quickly than we might have expected. This experience underlines the uncertainties and risks in any forecasting exercise. The projections of the Governors and Presidents are for a rather benign outlook, as are the views of many private sector forecasters. But these expectations can't convey the risks and subtleties in the developing economic situation.

A month or so ago, I noted publicly that a moderation in growth was both inevitable and desirable, but that the process could not reasonably be expected to be entirely smooth, and that accordingly the risks of a near term inventory-led recession, though small, had increased. More recent evidence suggests that we may have passed the point of maximum risk. But we have certainly not yet reached the point at which no risk of undue economic weakness remains. We do not as yet fully understand all the reasons for the degree of slowing in economic activity in the first half of the year, so we need to be somewhat tentative in our projections of a rebound. Imbalances seem to be limited, financial conditions should be supportive of spending, and businesses and consumers are largely optimistic about the future. Nonetheless, questions remain about the strength of demand for goods and services, not only in the United States but abroad as well.

Upside risks to the forecast also can be readily identified, particularly if the inventory correction is masking a much stronger underlying economy than appears from other evidence to be the case. If so, spending could strengthen appreciably, especially in light of the very substantial increases in financial market values so far this year.

In a transition period to sustainable growth such as this, reactions to unexpected events may be especially pronounced. This is not a time for the Federal Reserve to relax its surveillance of, and efforts to analyze, the evolving situation. The Federal Reserve must do its best to understand developing economic trends. While we cannot expect to eliminate cyclical booms and busts--human nature being what it is--we should nonetheless try where possible to reduce their amplitude.

Some observers have viewed prospective year-by-year budget-deficit reduction as constituting an important downside risk to the economy. I do not share this concern. In response to fiscal consolidation, financial markets provide an important shock absorber for the economy. Declines in long-term rates help stimulate private, interest-sensitive spending when government spending and transfers are reduced. Clearly, the Federal Reserve will have to watch this process carefully, and take the likely effects of fiscal policy into account in considering the appropriate stance in monetary

policy. But there is no doubt, in my judgment, that the net result of moving to budget balance will be a more efficient, more productive U S economy.

With regard to the money and debt ranges chosen by the FOMC for this year, the specifications for M2 and domestic nonfinancial debt were left unchanged, at 1 to 5 percent and 3 to 7 percent, respectively. The FOMC also made a purely technical upward revision to the M3 range. Last February's Humphrey-Hawkins testimony and report had noted the potential need for such a revision to this year's M3 range. Starting in 1989, the restructuring of thrift institutions and the difficulties facing commercial banks depressed their lending and their need for managed liabilities. The FOMC responded by reducing the upper and lower bounds of the range for M3 to below those of the M2 range. This year, M3 growth has begun to outpace that of M2, as it did for several decades prior to 1989. Overall credit flows have picked up some, and a higher proportion has gone through depositories. As a consequence, while M2 and debt remain within their respective annual ranges, M3 has appreciably overshoot the upper end of its range. The 2 percentage point increase in the upper and lower bounds of the M3 range to 2 to 6 percent was made in recognition of the evident return this year to a more normal pattern of M3 growth. The ranges specified for M2, M3, and debt this year also were provisionally carried over to 1996. The Committee

stressed that uncertainties about evolving relationships of these variables to income continued to impair their usefulness in policy

In summary, the economic outlook, on balance, is encouraging, despite the inevitable risks. The American economy rests on a solid foundation of entrepreneurial initiative and competitive markets. With the cyclical expansion more than likely to persist in the period ahead, the circumstances are particularly opportune for pressing forward with plans to institute further significant deficit reduction. For such actions, by raising the share of national saving available to the private sector, should foster declines in real interest rates and spur capital accumulation. Higher levels of capital investment in turn will raise the growth in productivity and living standards well into the next century.

The Federal Reserve believes that the main contribution it can make to enhancing the long-run health of the American economy is to promote price stability over time. Our short-run policy adjustments, while necessarily undertaken against the background of the current condition of the U.S. economy, must be consistent with moving toward the long-run goal of price stability. Our recent policy action to reduce the federal funds rate 25 basis points was made in this context. As I noted in my February testimony, easing would be appropriate if underlying forces were

clearly pointing toward reduced inflation pressures in the future. Considerable progress toward price stability has occurred across successive business cycles in the last 15 years. We at the Federal Reserve are committed to further progress in this direction.