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Statement by

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Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

U S Senate

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Mr Chairman and members of the Committee, I am pleased to appear here today. In July, the Federal Reserve submitted its semiannual report on monetary policy to the Congress. That report covered in detail the Federal Reserve's assessment of economic conditions and the forecasts of the Governors and Reserve Bank Presidents for economic growth and inflation. This morning, I would like to offer my views on recent developments.

As I reported earlier to the House Banking Committee, a moderation in economic activity in 1995 was inevitable following the frenetic pace of late 1994. It was also necessary if we were to avoid the creation of major inflationary instabilities. By the end of 1994, pressures on resources were contributing to sizable increases in delivery lead times for raw materials and intermediate goods and steep markups in their prices, overtime in manufacturing was extensive. Fortunately, economic growth has slowed appreciably this year, inflation risks have receded, and, as a consequence, the threat of severe recession has declined.

I also noted that one could not expect the transition to a more sustainable growth path to be entirely smooth. Rough patches were also encountered in past economic expansions, typically because businesses did not fully anticipate the changes in demand for output. The slowing in real GDP growth at the beginning of this year was precipitated by a weakening in consumer spending and housing construction, partly as a consequence of higher interest rates, and by the damper on net exports from the economic crisis in Mexico. But the risk of a more serious slowdown thereafter was exacerbated by the failure of inventory investment to match the slackening in spending. Indeed, although stocks in the aggregate remained modest, a few major

industries, such as motor vehicles and home goods, found themselves with substantial excesses. Attempts to control inventories triggered cutbacks in orders and output that, in turn, depressed employment and income in the spring.

At midyear the uncertainties about the dimension of the inventory adjustment, and thus about the prospects for real GDP over the near term, were considerable. Nonetheless, it seemed that the point of maximum risk of undue weakness had been passed and that moderate growth was likely to resume in the second half of the year. As events unfolded, revised data indicated that overall activity in the second quarter was not quite so weak as suggested by the initial estimates, largely because final sales were stronger. Moreover, the available statistical indicators for the current quarter are consistent with a firmer pace of economic growth. In the labor market, for example, payrolls have posted moderate increases, on average, over the past couple of months, and the unemployment rate has edged back down to 5.6 percent.

Industrial production also turned up in August after a sustained period of weakness that extended back to last winter. The surge in output should probably be discounted somewhat, given that this summer's unseasonably hot weather provided a transitory boost to the output of electricity. Moreover, in a number of industries where efforts to pare stocks are continuing, inventory-sales ratios remained on the high side in July. Even so, the production data suggest that, on balance, manufacturers were confident enough about their sales prospects--and, in the main, comfortable enough with their inventory positions--to expand production once again.

The underlying trends in final sales are favorable overall, in part because of the considerable decline in long-term interest

rates and the sharp increase in stock prices this year. Retail sales have been rising moderately, on average, since the spring, and home sales and starts have posted hefty gains. As for business investment, new orders for capital goods have fallen of late, but backlogs remain sizable. It thus appears that purchases of equipment will continue to grow, though perhaps at a slower pace than in the recent past. In addition, rising building permits point to further expansion in nonresidential construction.

Meanwhile, the inflation picture is looking more favorable than it did in early 1995. Core inflation--as proxied by the 12-month change in the CPI excluding food and energy--has moved back down to around 3 percent, after a bulge earlier in the year, and there appears little reason to expect much change in inflation trends in the near term. Increases in labor costs have remained modest even though unemployment has fallen to levels that history suggests might be associated with some acceleration in compensation. In addition, the deceleration in manufacturing activity this year has helped to ease pressures on capacity and to stabilize, and in many areas reduce, lead times on deliveries. And with supply and demand in global commodity markets in better balance, prices of materials and supplies are no longer rising rapidly. In light of these developments, the firming in monetary policy in 1994 and early 1995 appears to have been sufficient to head off a ratcheting up of inflation. As I have often stated, containing inflation, and over time eliminating it, is the main contribution the Federal Reserve can make to enhancing our long-run economic performance.

On the whole, the near-term prospects for the U.S. economy have improved in recent months, in part because the strong increases in financial market values this year are likely to provide substantial

support to household and business spending. But the outlook is not without concern. Firms' desired inventory levels are extremely difficult to gauge, and the remaining adjustment process could play out more negatively than we anticipate. Moreover, although the economies of our key trading partners are recovering somewhat, they are still expanding only moderately, on average, and, as a consequence, the external sector is unlikely to contribute positively to real GDP growth in the U S.

Some observers have expressed fears that current efforts to eliminate the federal budget deficit will prove a hindrance to the economy. I do not share those fears. Long-term interest rates have fallen a great deal this year, in part because of the growing probability that a credible, multiyear deficit reduction plan will be adopted. The declines in rates are already helping to stimulate private, interest-sensitive spending--providing, in effect, a shock absorber for the economy. Clearly, the Federal Reserve, in appraising evolving developments, will continue to take the likely effects of fiscal policy into account. But I have no doubt that the net result of moving the budget into balance will be a more efficient, more productive U S economy in the long run.

I continue to be impressed by the growing public recognition of the importance of deficit reduction--and the commitment on the part of the President and the Congress to bring the budget back into balance in the reasonably near future. The challenge is enormous. The budget deliberations will be contentious, and the deadlines now are extraordinarily tight. But these pressures must not be allowed to prevent us from taking concrete action to implement a program of credible multiyear deficit reduction. Failure to take such action would signal that the United States is not capable of putting its

fiscal house in order, with adverse and serious consequences for financial markets and long-term economic growth