

For release on delivery
9:30 A.M., E.S.T.
March 15, 1988

Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

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I am pleased to appear before this Committee to discuss the current economic situation and the outlook for 1988. As you know, the Federal Reserve submitted its semi-annual report on monetary policy to the Congress about three weeks ago. That report and the accompanying testimony discussed in some detail the monetary policy developments of 1987 and the FOMC's policy targets for 1988. Today, I would like to summarize briefly the main points of those reports and then turn to some more general considerations, particularly the process of external adjustment that is now underway and the challenge that it poses to our economy.

The overall record shows 1987 to have been another year of significant economic progress. Real gross national product rose nearly 4 percent over the course of the year, job growth totaled 3 million, and the unemployment rate

declined to 5-3/4 percent, its lowest level of the current decade.

Some sectors that had lagged earlier in the recovery exhibited particular strength last year. Buoyed by rising exports and a pickup in capital spending, industrial production in manufacturing surged 5-1/2 percent over the twelve months of 1987, and capacity utilization rose to its highest level in nearly eight years. Capacity use in the steel business was about 90 percent at the end of 1987, up from 65 percent a year earlier. Improvement also was evident in mining, oil extraction, and agriculture.

The year, however, was not without its setbacks. Inflation, which had dropped sharply in 1986, increased in 1987, owing to the bounce-back in oil prices and to the effects of the dollar's decline on prices of imported goods and their domestic substitutes. Concerns that these one-time price changes might trigger a more pronounced and more

deeply-rooted upswing in inflation persisted through late summer, surfacing, at one time or another, in the form of upward pressures on commodity prices or rising long-term interest rates. Under these conditions, further declines in the exchange value of the dollar added to the general uncertainty regarding longer-run price prospects.

For much of the year, Federal Reserve policy leaned in the direction of countering potential inflationary tendencies in the economy, while seeking to maintain a monetary and financial environment compatible with sustainable growth. The discount rate was raised on one occasion, and growth in M2 ran lower than the target range that the Federal Open Market Committee had established early in the year. In view of the very rapid money growth of 1986, the perceived inflation risks, the strength in the real economy and the marked variations in money velocity in

recent years, modest growth of the monetary aggregates was viewed as acceptable and appropriate.

The stock market crash of late October shifted the balance of risks, and the Federal Reserve modified its approach to monetary policy accordingly. In particular, we took steps to ensure adequate liquidity in the financial system during the period of serious turmoil, and we encouraged some decline in short-term interest rates as a precaution against the possibility of a significant retrenchment by households and businesses.

While some uneasiness still is apparent in the financial markets, the situation has calmed considerably since October. Interest rates have come down noticeably, and exchange rate pressures have moderated. In the real economy a buildup in business inventories late last year, coupled with the possibility that effects of the stock market crash might still be working through, suggested at

the turn of the year that the growth of real GNP might slow in the first part of 1988. However, employment has continued to advance early this year, and, at present, deep or prolonged cutbacks in production do not seem likely. Consumer spending seems to be holding its own, export prospects remain favorable, and capital goods orders have been strong. Overall, the chances appear relatively good for maintaining the current expansion through another year. As of mid-February, the central tendency of FOMC members' and other Reserve Bank presidents' forecasts was for growth of real GNP of around 2 to 2-1/2 percent from the fourth quarter of 1987 to the fourth quarter of 1988; this is a slower rate of growth than in 1987, but is probably close to what the economy can maintain on a long-run basis. Exports seem likely to provide a major impetus for growth in 1988, while the growth in domestic demand may be relatively slow.

With respect to inflation, price increases have picked up in some markets this past year. However, in general, business and labor still seem to be exercising a considerable degree of restraint in their wage and price-setting behavior, and bottlenecks are not a serious problem at the present time. Should the FOMC's forecasts of moderate growth of real GNP over the coming year be realized, this situation is not likely to change much. The FOMC central tendency forecast was for a rise in prices, as measured by the GNP deflator, of about 3-1/4 to 3-3/4 percent in 1988--similar to the inflation performance in most recent years.

The central tendency of our projections for real GNP growth encompasses the Administration forecast that you are reviewing today; the central tendency range for inflation is slightly below the Administration forecast, but the difference is not significant.

In formulating its policy objectives for 1988, the Federal Open Market Committee, at its mid-February meeting, established monetary target ranges of 4 to 8 percent for both M2 and M3 over the four quarters of 1988. Expansion of money within these ranges is expected to support continued economic growth at a pace that is consistent with progress over time toward price stability. In recent years, of course, the relation of money to income has not been very stable. Accordingly, as the coming year unfolds, we will continue to keep a close eye not only on the behavior of the aggregates, but also on the overall performance of the economy.

Although the near-term prospects thus look reasonably encouraging, major uncertainties remain and we should not be complacent about the nation's economic future. To a considerable extent, we still are sailing in uncharted waters and are facing adjustments that have no precedent in

our recent history. A couple of decades ago, we still viewed our economy as being relatively self-contained. We thought of business cycles largely in terms of domestic spending, inventories and production; foreign trade did not play a major role. Businesses saw their competition as being the firm down the road or in the next city or state, not the producer on the other side of the world. We recognized, of course, that American economic activity and policies materially affected the rest of the world. Developments outside our borders, however, appeared to have little impact on economic activity in this country.

This has all changed in recent years. Our economy today is being driven by external forces and is coming to resemble more nearly the open, trade-based economies of Europe than the insulated economy of our own past. We are increasingly affected by developments outside our borders and need to learn to do business there. Despite the

attendant complications, our own policies are going to have to be shaped with close surveillance of what is happening in the rest of the world.

Particularly striking evidence of a changed economic climate was the deterioration of our external balance over the first half of the 1980s, a period in which import growth far outpaced the rise in exports. The causes of this imbalance were complex, but its effects on consumers and businesses were relatively clear. Consumers benefitted from having access to a broad range of good-quality imports, while the producing sectors that are heavily affected by foreign trade suffered a loss of market share, both domestically and worldwide. In manufacturing, which accounts for nearly two-thirds of our exports, production was sluggish, layoffs mounted, and pressures for protectionism rose. Agriculture also suffered as the export boom of the 1970s turned into the export bust of the 1980s.

Overall, from mid-1980 to the summer of 1986, real net exports of goods and services fell by an amount equal to 6 percent of real GNP.

Fortunately, this situation has started to change. In volume terms, our external sector has been improving and accounted for nearly half a percentage point of GNP growth over the four quarters of 1987. As I noted earlier, manufacturing growth was especially robust last year, and the current backlog of orders suggests that factory output should be well-maintained over the near-term.

However, just as the deterioration of our external account created serious dislocations for the domestic economy in recent years, the swing back toward better balance also may create difficulties, though of a different nature. These adjustments--and the way that we deal with them--will go far toward shaping the economic outlook for a number of years to come.

Let me illustrate by drawing some comparisons between the current situation and other episodes from our recent economic history. When real exports bottomed out in the summer of 1986, the nation's total spending for goods and services, including inventory investment, exceeded the comparable domestic production of goods and services by about 4-1/4 percent, a gap unprecedented for the postwar period. By comparison, production and spending were closely matched throughout much of the 1950s and 1960s; and even in the more volatile decade of the 1970s, spending did not depart from production by more than a couple of percentage points.

Those smaller gaps of the 1970s eventually closed, largely because of growth in the volume of exports. But the transitions back toward external balance were not smooth, either in the early part of the decade or in the late 1970s. Rather, the transitions were marked by strongly competing

demands on domestic resources, an overheating of product markets, and widespread inflationary pressures.

Of course, history does not have to repeat itself, and in harkening back to these past episodes, I do not mean to suggest that the economy will inevitably follow a similar path in the years immediately ahead. Indeed, the world is more competitive than it was 10 or 15 years ago, and recognition by business and labor of the need to stay competitive may help to quell whatever latent inflationary tendencies arise.

What is clear is that a major adjustment is underway. As part of the move back toward external balance, export growth could place stronger demands on a domestic resource base that already is operating at high levels of utilization in some areas. To date, lead times in the deliveries of production materials remain moderate, implying for the moment little pressure from capacity restraints. Never-

theless, our experience from the 1970s, when smaller external adjustments took place, should make us cautious about thinking that this adjustment can be accomplished without some upward pressures on prices. Ideally, one can conceive of a strengthening of exports meshing neatly with a slowing of domestic spending in such a way as to maintain utilization levels for labor and capital without overheating. Certainly, if, as I noted earlier, growth is moderate in the period ahead, bottlenecks should not be a serious problem. Realistically, however, one has to recognize that events in the real world may not mesh as neatly as contemplated and that the adjustment may not proceed as smoothly as we would like.

Although the exact path of adjustment cannot be predicted with precision, we know that there are a number of actions that can be taken to help make the process smoother than would otherwise be the case.

Monetary policy needs to remain supportive of the expansion but also alert to the possibility of a re-emergence of inflation. Policymakers must be especially mindful that the cost of temporizing in the face of accumulating price pressures would be a far more serious and painful adjustment down the road.

After several years of debate, Congress is understandably tired of wrestling with the budget deficit issue. The temptation is great to lay it aside for a year or permit small retreats from the real progress that has been achieved to date. However, there are risks in delaying or retreating, even a little, on an issue of such great importance. It is urgent that the Congress fully implement the deficit-reduction measures agreed to in December and continue to consider additional measures that might be taken to lock in further progress in the outyears.

As part of the coming adjustment, this nation must find ways of generating sufficient domestic saving to finance investment and maintain the productivity gains that are needed to keep us competitive in world markets. Over the course of the expansion, the adverse implications of a low domestic saving rate have been temporarily obscured, as a large inflow of capital from abroad has made it possible to finance a large federal deficit and a high level of consumption and investment spending without undue pressures on the credit markets. However, there are limits to how long a country can depend upon savings from abroad, and at some point we will have to revert to financing our future from our own resources. Indeed, the pressures experienced in the foreign exchange and financial markets last year suggest that those limits are closer than they were before.

Nor can we count on a major pickup in private saving. We have endeavored in recent decades to implement

tax policies to augment household and business saving; however, these policies have not been demonstrably successful. Accordingly, it will become doubly important for the federal government to reduce its demands on the credit markets by cutting the budget deficit. Indeed, as I have suggested previously, we may have to consider at some point whether the nation's inability to boost private saving argues for a federal budget policy aimed at generating surpluses.

Foreign governments also must play a part, if the adjustment process is to work smoothly in the context of a growing world economy. During most of this expansion, the purchases of goods by U.S. businesses and households have provided a strong impetus for production gains abroad. Now that process must work in reverse. Other countries need to promote growth in their economies, reduce trade barriers, and in general ensure receptive markets for exports from the

United States and elsewhere. The chances of attaining access to markets abroad would be damaged, of course, if the United States itself were to embrace greater protectionism, a temptation that I earnestly hope we will avoid.

Let me conclude, Mr. Chairman, by saying that I view the outlook as satisfactory, but not without risks. Our economy was dealt a potentially severe shock last October, and at present, we seem to be weathering that shock perhaps better than might have been expected. Looking ahead, we know that the economy will be heavily influenced by the ongoing correction of fundamental internal and external imbalances. However, the broad contours of the coming adjustment are relatively clear and should not come to us as a surprise. Although our place in the world is changing, the future can be prosperous if we remain

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attentive to the course of events and take those actions
that we know are needed.

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