

Testimony of Chairman Alan Greenspan

The Federal Reserve's semiannual monetary policy report

Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

July 21, 1998

Chairman Greenspan presented identical testimony before the Subcommittee on Domestic and International Monetary Policy of the Committee on Banking and Financial Services, U.S. House of Representatives, July 22, 1998

Mr. Chairman and members of the Committee, I appreciate this opportunity to present the Federal Reserve's [midyear report on monetary policy](#).

Overall, the performance of the U.S. economy continues to be impressive. Over the first part of the year, we experienced further gains in output and employment, subdued prices, and moderate long-term interest rates. Important crosscurrents, however, have been impacting the economy. With labor markets very tight and domestic final demand retaining considerable momentum, the risks of a pickup in inflation remain significant. But inventory investment, which was quite rapid late last year and early this year, appears to have slowed, perhaps appreciably. Moreover, the economic and financial troubles in Asian economies are now demonstrably restraining demands for U.S. goods and services--and those troubles could intensify and spread further. Weighing these forces, the Federal Open Market Committee chose to keep the stance of policy unchanged over the first half of 1998. However, should pressures on labor resources begin to show through more impressively in cost increases, policy action may need to counter any associated tendency for prices to accelerate before it undermines this extraordinary expansion.

Recent Developments

When I appeared before your committee in February, I noted that a key question for monetary policy was whether the consequences of the turmoil in Asia would be sufficient to check inflationary tendencies that might otherwise result from the strength of domestic spending and tightening labor markets. After the economy's surge in 1996 and, especially, last year, resource utilization, particularly that of the labor force, had risen to a very high level. Although some signs pointed to stepped-up increases in productivity, the speed at which the demand for goods and services had been growing clearly exceeded the rate of expansion of the economy's long-run potential to produce. Maintenance of such a pace would put even greater pressures on the economy's resources, threatening the balance and longevity of the expansion.

However, it appeared likely that the difficulties being encountered by Asian economies, by cutting into U.S. exports, would be a potentially important factor slowing the growth of aggregate demand in the United States. But uncertainties about the timing and dimensions of that development were considerable given the difficulties in assessing the extent of the problems in East Asia.

In the event, the contraction of output and incomes in a number of Asian economies has turned out to be more substantial than most had anticipated. Moreover, financial markets in Asia and in emerging market economies generally have remained unsettled, portending further difficult adjustments. The contraction in Asian economies, along with the rise in the foreign exchange value of the dollar over 1997, prompted a sharp deterioration in the U.S. balance of trade in the first quarter. Nonetheless, the American economy proved to be unexpectedly robust in that period. The growth of real GDP not only failed to slow, it climbed further, to about a 5-1/2 percent annual rate in the first quarter, according to the current national income accounts. Domestic private demand for goods and services--including personal consumption expenditures, business investment, and residential expenditures--was exceptionally strong.

Evidently, optimism about jobs, incomes, and profits, high and rising wealth-to-income ratios, low financing costs, and falling prices for high-tech goods fed the appetites of households and businesses for consumer durables and capital equipment. In addition, inventory investment contributed significantly to growth in the first quarter; indeed, the growth of stocks of materials and goods outpaced that of overall output by a wide margin during the first quarter, adding 1 percentage points to the annualized growth rate of GDP. Although accumulation of some products likely was unintended, surveys indicate that much of the stockbuilding probably reflected firms' confidence in the prospects for continued growth.

As evidence piled up that the economy continued to run hot during the winter, the Federal Reserve's concerns about inflationary pressures mounted. Domestic demand clearly had more underlying momentum than we had anticipated, supported in part by financial conditions that were quite accommodative. Credit remained extremely easy for most borrowers to obtain; intermediate- and long-term interest rates were at relatively low levels; equity prices soared higher, despite some disappointing earnings reports; and growth in the monetary aggregates was rapid. Indeed, the crises in Asia, by lowering longer-term U.S. interest rates--through stronger preferences for dollar investments and expectations of slower growth ahead--and by reducing commodity prices, probably added to the positive forces boosting domestic spending in the first half, especially in the interest-sensitive housing sector. The robust expansion of demand tightened labor markets further, giving additional impetus to the upward trend in labor costs. Inflation was low--though, given the lags with which monetary policy affects the economy and prices, we had to be mainly concerned not with conditions at the moment but with those likely to prevail many months ahead. In these circumstances, the Federal Open Market Committee elected in March to move to a state of heightened alert against inflation, but left the stance of policy unchanged.

Although national income and product data for the second quarter have not yet been published, growth of U.S. output appears to have slowed sharply. The auto strike has brought General Motor's production essentially to a halt, probably reducing real GDP in the second quarter by about 1/2 percentage point at an annual rate. The limited available information on inventory investment suggests that stockbuilding dropped markedly from its unsustainable pace of the first quarter. In addition to the slower pace of inventory building, Asian economies have continued to deteriorate, further retarding our exports in recent months.

Indeed, readings on the elements that make up the real GDP have led many analysts to anticipate a decline in that measure in the second quarter, after the first-quarter surge. Given

the upcoming revisions to the national income accounts, such assessments would have to be regarded as conjectural. It is worth noting in any case that other indicators of output, including worker hours and manufacturing production, show a somewhat steadier, though slowing, path over the first half of the year. And underlying trends in domestic final demand have remained strong, imparting impetus to the continuing economic expansion.

During the first half of the year, measures of resource utilization diverged. Pressures on manufacturing facilities appeared to be easing. Plant capacity was growing rapidly as a result of vigorous investment. And growth of industrial output was dropping off from its brisk pace of 1997, importantly reflecting the deceleration in world demand for manufactured goods that resulted from the Asian economic difficulties.

But labor markets, in contrast, became increasingly taut during the first half. Total payroll jobs rose about one-and-one-half million over the first six months of the year. The civilian unemployment rate dropped to a bit below 4-1/2 percent in the second quarter, its lowest level in three decades. Firms resorted to a variety of tactics to attract and retain workers, such as paying various types of monetary bonuses and raising basic wage rates. But, at least through the first quarter, the effects of a rising wage bill on production costs were moderated by strong gains in productivity.

Indeed, inflation stayed remarkably damped during the first quarter. The consumer price index as well as broader measures of prices indicate that inflation moved down further, even as the economy strengthened. Although declining oil prices contributed to this development, pricing leverage in the goods-producing sector more generally was held in check by reduced demand from Asia that, among other things, has led to a softening of commodity prices, a strong dollar that has contributed to bargain prices on many imports, and rising industrial capacity. Service price inflation, less influenced by international events, has remained steady at about a 3 percent rate since before the beginning of the crisis.

Some elements in the goods price mix clearly were transitory. Indeed, the more recent price data suggest that overall consumer price inflation moved up in the second quarter. But, even so, the increase remained moderate.

In any event, it would be a mistake for monetary policy makers to focus on any single index in gauging inflation pressures in the economy. Although much public attention is directed to the CPI, the Federal Reserve monitors a wide variety of aggregate price measures. Each is designed for a particular purpose and has its own strengths and weaknesses. Price pressures appear especially absent in some of the measures in the national income accounts, which are available through the first quarter. The chain-weight price index for personal consumption expenditures excluding food and energy, for example, rose 1.5 percent over the year ending in the first quarter, considerably less than the 2.3 percent rise in the core CPI over the same period. An even broader price measure, that for overall GDP, rose 1.4 percent. These indexes, while certainly subject to many of the measurement difficulties the Bureau of Labor Statistics has been grappling with in the CPI, have the advantages that their chain-weighting avoids some aspects of so-called substitution bias and that already published data can be revised to incorporate new information and measurement techniques. Taken together, while the various price indexes show some differences, the basic message is that inflation to date has remained low.

Economic Fundamentals: The Virtuous Cycle

So far this year, our economy has continued to enjoy a virtuous cycle. Evidence of accelerated productivity has been bolstering expectations of future corporate earnings, thereby fueling still further increases in equity values, and the improvements in productivity have been helping to reduce inflation. In the context of subdued price increases and generally supportive credit conditions, rising equity values have provided impetus to spending and, in turn, the expansion of output, employment, and productivity-enhancing capital investment.

The essential precondition for the emergence, and persistence, of this virtuous cycle is arguably the decline in the rate of inflation to near price stability. In recent years, continued low product price inflation and expectations that it will persist have promoted stability in financial markets and fostered perceptions that the degree of risk in the financial outlook has been moving ever lower. These perceptions, in turn, have reduced the extra compensation that investors require for making loans to, or taking ownership positions in, private firms. With risks in the domestic economy judged to be low, credit and equity capital have been readily available for many businesses, fostering strong investment. And low mortgage interest rates have allowed many households to purchase homes and to refinance outstanding debt. The reduction in debt servicing costs has contributed to an apparent stabilization of the financial strains on the household sector that seemed to emerge a couple of years ago and has buoyed consumer demand.

To a considerable extent, investors seem to be expecting that low inflation and stronger productivity growth will allow the extraordinary growth of profits to be extended into the distant future. Indeed, expectations of earnings growth over the longer term have been undergoing continual upward revision by security analysts since early 1995. These rising expectations have, in turn, driven stock prices sharply higher and credit spreads lower, perhaps in both cases to levels that will be difficult to sustain unless the virtuous cycle continues. In any event, primarily because of the rise in stock prices, about \$12-1/2 trillion has been added to the value of household assets since the end of 1994. Probably only a few percent of these largely unrealized capital gains have been transformed into the purchase of goods and services in consumer markets. But that increment to spending, combined with the sharp increase in equipment investment, which has stemmed from the low cost of both equity and debt relative to expected profits on capital, has been instrumental in propelling the economy forward.

The consequences for the American worker have been dramatic and, for the most part, highly favorable. A great many chronically underemployed people have been given the opportunity to work, and many others have been able to upgrade their skills as a result of work experience, extensive increases in on-the-job training, or increased enrollment in technical programs in community colleges and elsewhere. In addition, former welfare recipients appear to have been absorbed into the work force in significant numbers.

Government finances have been enhanced as well. Widespread improvement has been evident in the financial positions of state and local governments. In the federal sector, the taxes paid on huge realized capital gains and other incomes related to stock market advances, coupled with taxes on markedly higher corporate profits, have joined with restraint on spending to produce a unified budget surplus for the first time in nearly three decades. The important steps taken by the Congress and the Administration to put federal finances on a sounder footing have added to national saving, relieving pressures on credit markets. The paydown of debt associated with the federal surplus has helped to hold down

longer-term interest rates, which in turn has encouraged capital formation and reduced debt burdens. Maintaining this disciplined budget stance would be most helpful in supporting a continuation of our current robust economic performance in the years ahead.

The fact that economic performance has strengthened as inflation subsided should not have been surprising, given that risk premiums and economic disincentives to invest in productive capital diminish as the economy approaches price stability. But the extent to which strong growth and high labor force utilization have been joined with low inflation over an extended period is, nevertheless, exceptional. So far, at least, the adverse wage-price interactions that played so central a role in pressuring inflation higher in many past business expansions--eventually bringing those expansions to an end--have not played a significant role in the current expansion.

For one thing, increases in hourly compensation have been slower to pick up than in most other recent expansions, although, to be sure, wages have started to accelerate in the past couple of years as the labor market has become progressively tighter. In the first few years of the expansion, the subdued rate of rise in hourly compensation seemed to be, in part, a reflection of greater concerns among workers about job security. We now seem to have moved beyond that phase of especially acute concern, though the flux of technology may still be leaving many workers with fears of job skill obsolescence and a willingness to trade wage gains for job security. In the past couple of years, of course, workers have not had to press especially hard for nominal pay gains to realize sizable increases in their real wages. In contrast to the pattern that developed in several previous business expansions, when workers required substantial increases in pay just to cover increases in the cost of living, consumer prices have been generally well-behaved in the current expansion.

A couple of years ago--almost at the same time that increases in total hourly compensation began trending up in nominal terms--evidence of a long-awaited pickup in the growth of labor productivity began to show through more strongly in the data; and this accelerated increase in output per hour has enabled firms to raise workers' real wages while holding the line on price increases. Gains in productivity usually vary with the strength of the economy, and the favorable results that we have observed during the past two years or so, when the economy has been growing more rapidly, almost certainly overstate the degree of structural improvement. But evidence continues to mount that the trend of productivity has accelerated, even if the extent of that pickup is as yet unclear. Signs of major technological improvements are all around us, and the benefits are evident not only in high-tech industries but also in production processes that have long been part of our industrial economy.

Those technological innovations and the rapidly declining cost of capital equipment that embodies them in turn seem to be a major factor behind the recent enlarged gains in productivity. Evidently, plant managers who were involved in planning capital investments anticipated that a significant increase in the real rates of return on facilities could be achieved by exploiting emerging new technologies. If that had been a mistake on their part, one would have expected capital investment to run up briefly and then start down again when the lower-than-anticipated rates of return developed. But we have instead seen sustained gains in investment, indicating that hoped-for rates of return apparently have been realized.

Notwithstanding a reasonably optimistic interpretation of the recent productivity numbers, it would not be prudent to assume that even strongly rising productivity, by itself, can ensure a

non-inflationary future. Certainly wage increases, per se, are not inflationary, unless they exceed productivity growth, thereby creating pressure for inflationary price increases that can eventually undermine economic growth and employment. Because the level of productivity is tied to an important degree to the stock of capital, which turns over only gradually, increases in the trend growth of productivity probably also occur rather gradually. By contrast, the potential for abrupt acceleration of nominal hourly compensation is surely greater.

As I have noted in previous appearances before Congress, economic growth at rates experienced on average over the past several years would eventually run into constraints as the reservoir of unemployed people available to work is drawn down. The annual increase in the working-age population (from 16 to 64 years of age), including immigrants, has been approximately 1 percent a year in recent years. Yet employment, measured by the count of persons who are working rather than by the count of jobs, has been rising 2 percent a year since 1995, despite the acceleration in the growth of output per hour. The gap between employment growth and population growth, amounting to about 1.1 million persons a year on average since the end of 1995, has been made up, in part, by a decline in the number of individuals who are counted as unemployed--those persons who are actively seeking work--of approximately 650,000 a year, on average, over the past two and one-half years. The remainder of the gap has reflected a rise in labor force participation that can be traced largely to a decline of almost 300,000 a year in the number of individuals (aged 16 to 64) wanting a job but not actively seeking one. Presumably, many of the persons who once were in this group have more recently become active and successful job-seekers as the economy has strengthened, thereby preventing a still sharper drop in the official unemployment rate. In June, the number of persons aged 16 to 64 who wanted to work but who did not have jobs was 10.6 million on a seasonally adjusted basis, roughly 6 percent of the working-age population. Despite an uptick in joblessness in June, this percentage is only fractionally above the record low reached in May for these data, which can be calculated back to 1970.

Nonetheless, a strong signal of inflation pressures building because of compensation increases markedly in excess of productivity gains has not yet clearly emerged in this expansion. Among nonfinancial corporations (our most recent source of data on consolidated income statements), trends in costs seem to have accelerated from their lows, but the rates of increase in both unit labor costs and total unit costs are still quite low.

Still, the gap between the growth in employment and that of the working-age population will inevitably close. What is crucial to sustaining this unprecedented period of prosperity is that it close reasonably promptly, given already stretched labor resources, and that labor markets find a balance consistent with sustained growth marked by compensation gains in line with productivity advances. Whether these adjustments will occur without monetary policy action remains an open question.

Foreign Developments

While the United States has been benefiting from a virtuous economic cycle, a number of other economies unfortunately have been spiraling in quite the opposite direction. The United States, Canada, and Western Europe have been enjoying solid economic growth, with relatively low inflation and declining unemployment, but the economic performance in many developing and transition nations and Japan has been deteriorating. How quickly the latter erosion is arrested and reversed will be a key factor in shaping U.S. economic and financial trends in the period ahead. With all that is at stake, it would be difficult to overstate

how crucial it is that the authorities in the relevant economies promptly implement effective policies to correct the structural problems underlying recent weaknesses and to promote sustainable economic growth before patterns of reinforcing contraction become difficult to contain.

Conditions in Asia are of particular concern. Aggregate output of the Asian developing economies has plunged, with particularly steep declines in Korea, Malaysia, Thailand, and Indonesia. Even the economies of the stalwart tigers--Hong Kong, Singapore, and Taiwan--have softened. Economic growth in China has also slowed, owing largely to the currency depreciations among its neighbors and the sharp declines in their demand for imports.

Russia has also experienced some spillover from the Asian difficulties, but Russia's problems are mostly homegrown. Large fiscal deficits stem from high effective marginal tax rates that encourage avoidance and do not raise adequate revenue. This and the recent declines in prices of oil and other commodities have rendered Russian financial markets and the ruble vulnerable, particularly in an environment of heightened concern about all emerging markets. The Russian government has recently promulgated a set of new policy measures in connection with an expanded IMF support package in an effort to address these problems.

In Latin America, conditions vary: Economies that are heavily dependent on exports of oil and other commodities have suffered as prices of those items have fallen, and several countries in that region have received more intensive scrutiny in international capital markets, but, on the whole, Latin American economies continue to perform reasonably well.

Disappointingly, economic activity in Japan--a crucial engine of Asian economic growth--has turned down after a long period of subpar growth. Gross domestic product fell at a 5-1/4 percent annual rate in the first quarter. More recently, confidence of households and businesses has continued to erode, the sharp contraction elsewhere in Asia has fed back onto Japan, and the dwindling domestic demand for goods and services in that country has been further constrained by a mounting credit crunch. Nonperforming loans have risen sharply as real estate values fell following the bursting of the asset bubble in 1991. Problems in the banking sector, exacerbated by the broader Asian financial crisis, have led to market concerns about the adequacy of the capital of many Japanese banks and have engendered a premium in the market for Japanese banks' borrowing. This resulting squeeze to profit margins has led to a reluctance to lend in dollars or yen. In response to the weakening economy and deteriorating banking situation, the Japanese yen has tended to weaken significantly, in often-volatile markets, against the dollar and major European currencies.

As you know, we have sought to be helpful in the Japanese government's efforts to stabilize their economy and financial system, reflecting our awareness of the important role that Japanese financial and economic performance plays in the world economy, including that of the United States. We have consulted with the relevant Japanese authorities on methods for resolving difficulties in their banking system and have urged them to take effective measures to stimulate their economy. I believe that the Japanese authorities recognize the urgency of the situation.

That a number of foreign economies are currently experiencing difficulties is not surprising. Although many had previously realized a substantial measure of success in developing their economies, a number had leaned heavily on command-type systems rather than relying

primarily on market mechanisms. This characteristic has been evident not only in their industrial sectors but in banking where government intervention is typically heavy, where long-standing personal and corporate relationships are the predominant factor in financing arrangements, and where market-based credit assessments are the exception rather than the rule. Recent events confirm that these sorts of structures are ill-suited to today's dynamic global economy, in which national economies must be capable of adapting flexibly and rapidly to changing conditions.

Responses in countries currently experiencing difficulties have varied considerably. Some have reacted quickly and, in general terms, appropriately. But in others, a variety of political considerations appear to have militated against prompt and effective action.

As a consequence, the risks of further adverse developments in these economies remain substantial. And given the pervasive interconnections of virtually all economies and financial systems in the world today, the associated uncertainties for the United States and other developed economies remain substantial as well.

In the current circumstances, we need to be aware that monetary policy tightening actions in the United States could have outsized effects on very sensitive financial markets in Asia, a development that could have substantial adverse repercussions on U.S. financial markets and, over time, on our own economy. But while we must take account of such foreign interactions, we must be careful that our responses ultimately are consistent with a monetary policy aimed at optimal performance of the U.S. economy. Our objectives relate to domestic economic performance, and price stability and maximum sustainable economic growth here at home would best serve the long-run interests of troubled financial markets and economies abroad.

The Economic Outlook

The Federal Open Market Committee believes that the conditions for continued growth with low inflation are in place here in the United States. As I noted previously, an important issue for policy is how the imbalance of recent years between the demand for labor and the growth of the working-age population is resolved. In that regard, we see a slowing of the growth in aggregate demand as a necessary element in the mix.

At this time, some of the key factors that have supported strong final demand by domestic purchasers remain favorable. Although real short-term interest rates have risen as the federal funds rate has been held unchanged while inflation expectations have declined, the financial conditions that have fostered the strength in demand are still in place. With their incomes and wealth having been on a strong upward track, American consumers remain quite upbeat. For businesses, decreasing costs of and high rates of return on investment, as well as the scarcity of labor, could keep capital spending elevated. These factors suggest some risk that the labor market could get even tighter. And even if it does not, under prevailing tight labor markets increasingly confident workers might place gradually escalating pressures on wages and costs, which would eventually feed through to prices.

But a number of factors likely will serve to damp growth in aggregate demand, helping to foster a reasonably smooth transition to a more sustainable rate of growth and reasonable balance in labor markets. We have yet to see the full effects of the crisis in East Asia on U.S. employment and income. Residential and business fixed investment already have reached such high levels that further gains approaching those experienced recently would

imply very rapid growth of the stocks of housing and plant and equipment relative to income trends. Moreover, business investment will be damped if recent indications of a narrowing in domestic operating profit margins prompt a reassessment of the expected rates of return on investment in plant and equipment. Reduced prospects for the return to capital would not only affect investment directly but could also affect consumption if stock prices adjust to a less optimistic view of earnings prospects.

Of course, the demand for labor that is consistent with a particular rate of output growth also could be lowered if productivity growth were to increase more. And, on the supply side of the labor market, faster growth of the labor force could emerge as the result of increased immigration or delayed retirements. Nonetheless, it appears most probable that the necessary slower absorption of labor into employment will reflect, in part, a deceleration of output growth, as a consequence of evolving market forces. Failing that, firming actions on the part of the Federal Reserve may be necessary to ensure a track of expansion that is capable of being sustained.

Thus, members of the Board of Governors and presidents of the Federal Reserve Banks anticipate a slowing in the rate of economic growth. The central tendency of their forecasts is that real GDP will rise 3 to 3-1/4 percent over 1998 as a whole and 2 to 2-1/2 percent in 1999. With the rise in the demand for workers coming into line with that of the labor force, the unemployment rate is expected to change little from its current level, finishing next year in the neighborhood of 4-1/2 to 4-3/4 percent.

Inflation performance will be affected by developments abroad as well as those here at home. The extent and pace of recovery of Asian economies currently experiencing a severe downturn will have important implications for prices of energy and other commodities, the strength of the dollar, and competitive conditions on world product markets. Should the situation abroad remain unsettled, these factors would probably continue to contribute to good price performance in the United States in the period ahead. But it is important to recognize that the damping influence of these factors on inflation is mostly temporary. At some point, the dollar will stop rising, foreign demand will begin to recover, and oil and other commodity prices will stop falling and could even back up some. Indeed, a brisk snap-back in foreign economic activity, should that occur, would add, at least temporarily, to price pressures in the United States.

On a more fundamental level, it is the balance of supply and demand in labor and product markets in the United States that will have the greatest effect on inflation rates here. As I noted previously, wage and benefit costs have been remarkably subdued in the current expansion. Nonetheless, an accelerating trend in wages has been apparent for some time.

In addition, a gradual upward tilt in benefit costs has become evident of late. A variety of factors--including the strength of the economy and rising equity values, which have reduced the need for payments into unemployment trust funds and pension plans, and the restructuring of the health care sector--have been working to keep benefit costs in check in this expansion. But, in the medical area at least, the most recent developments suggest that the favorable trend may have run its course. The slowing of price increases for medical services seems to have come to a halt, at least for a time, and, with the cost-saving shift to managed care having been largely completed, the potential for businesses to achieve further savings in that regard appears to be rather limited at this point. There have been a few striking instances this past year of employers boosting outlays for health benefits by

substantial amounts.

Given that compensation costs are likely to accelerate at least a little further, productivity trends and profit margins will be key to determining price performance in the period ahead. Whether the recent strong performance of productivity can be extended remains to be seen. It does seem likely that productivity calculated for the entire economy using GDP data weakened in the second quarter. This development clearly owed, at least in some degree, to the deceleration of output in that period. In manufacturing, where our data are better measured, productivity appears still to have registered a solid increase. We will be closely monitoring a variety of indicators to assess how productivity is performing in the months ahead.

Monetary policymakers see the most likely outcome as modestly higher inflation rates in the next one and one-half years. The central tendency of monetary policymakers' CPI inflation forecasts is for an increase of 1-3/4 to 2 percent during 1998 and 2 to 2-1/2 percent next year. As noted, the ebbing of the special factors reducing inflation over the past year or so, such as the decline in oil prices, will account for some of this uptick. But the Federal Open Market Committee will need to remain particularly alert to the possibility that more fundamental imbalances are increasing inflationary pressures. The Committee would need to resist vigorously any tendency for an upward trend, which could become embedded in the inflationary process.

The Committee recognizes that significant risks attend the outlook: One is that the impending constraint from domestic labor markets could bind more abruptly than it has to date, intensifying inflation pressures. The other is the potential for further adverse developments abroad, which could reduce the demand for U.S. goods and services more sharply than anticipated and which would thereby ease pressures on labor markets. While we expect that the situation will develop relatively smoothly, the Committee believes that, given the current tightness in labor markets, the potential for accelerating inflation is probably greater than the risk of protracted, excessive weakness in the economy. In any case, it will need to continue to monitor evolving circumstances closely, and adjust the stance of monetary policy as appropriate, in order to help establish conditions consistent with progress towards the Federal Reserve's goals of price stability and maximum sustainable economic growth.

Ranges for Money and Credit Growth

Indeed, recognition of the benefits of low inflation and our commitment to the Federal Reserve's statutory objective of price stability were once again dominant in the Committee's semiannual review of the ranges for the monetary and debt aggregates. The FOMC noted that the behavior of the monetary aggregates had been somewhat more predictable over the past few years than it had been earlier in the 1990s. The rapid growth of M2 and M3 over the first half of the year, which lifted those measures above the upper ends of the target ranges established in February, was consistent with the unexpectedly strong advance in aggregate demand. However, movements in velocity remain difficult to predict.

The FOMC will continue to interpret the monetary ranges as benchmarks for the achievement of price stability under conditions of historically normal velocity behavior. Consistent with that interpretation, the Committee decided to retain the current ranges for the monetary aggregates for 1998, as well as the range for debt, and to carry them over on a provisional basis to next year. Although near-term prospects for velocity behavior are

uncertain, the Committee recognizes that monetary growth does appear to provide some information about trends in the economy and inflation. Therefore, we will be carefully evaluating the aggregates, relative both to forecasts and to their ranges, in the context of other readings on other variables in our efforts to promote optimum macroeconomic conditions.

Concluding Comments

As I have stated in previous testimony, the recent economic performance, with its combination of strong growth and low inflation, is as impressive as any I have witnessed in my near half-century of daily observation of the American economy. Although the reasons for this development are complex, our success can be attributed in part to sound economic policy. The Congress and the Administration have successfully balanced the budget and, indeed, achieved a near-term surplus, a development that tends to boost national saving and investment. The Federal Reserve has pursued monetary conditions consistent with maximum sustainable long-run growth by seeking price stability. These policies have helped bring about a healthy macroeconomic environment for productivity-boosting investment and innovation, factors that have lifted living standards for most Americans. The task before us is to maintain disciplined economic policies and thereby contribute to maintaining and extending these gains in the years ahead.

[July 1998 Humphrey-Hawkins report](#) | [1998 Testimony](#)

[Home](#) | [News and events](#) | [Monetary policy](#)
[Accessibility](#) | [Contact Us](#)

Last update: July 22, 1998, 10:00 AM