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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 appreciate the opportunity to appear again before this Committee in my still-new capacity. Some years have passed since I had the privilege of appearing, with some frequency as an official of the Treasury. I note with pleasure the continuity of membership on the Committee. I know in some cases that membership spans decades, and the Committee has played a prominent role through the years in enhancing economic understanding and policy-making. The Federal Reserve, as so many others, has benefitted from the dialogue.

I belabor the obvious when I say we face unpleasant economic circumstances, and that none of our choices is risk-free or pain-free. At the same time, the clear and widespread public perception that the problems are difficult, but that the time has come to deal with them, provides us with an important opportunity to put in place and sustain forceful and appropriate policies.

Monetary policies can only be a part of the overall framework. But they are an essential part.

It is not necessary to recite all the details of the long series of events that have culminated in the serious inflationary environment that we are now experiencing. An entire generation of young adults has grown up since the mid-1960's knowing only inflation, indeed an inflation that has seemed to accelerate inexorably. In the circumstances, it is hardly surprising that many citizens have begun to wonder whether it is realistic to anticipate a return to general price stability, and have begun to change their behavior accordingly. Inflation feeds in part on itself, so part of the job of returning to a more stable and more productive economy must be to break the grip of inflationary expectations.

We have recently seen clear evidence of the pervasive influence of inflation and inflationary expectations on the orderly functioning of financial and commodity markets, and on the value of the dollar internationally. Over a longer period of time, the uncertainties and distortions inherent in inflation have had a debilitating influence on investment, productivity and growth. In the circumstances, the overwhelming feeling in the nation -- that we must come to grips with the problem -- reflects the common sense of the American people. At the same time, we have to recognize that, after more than four years of expansion, there are widespread anticipations of inventory adjustments and a downturn in economic activity. The challenge is to deal with this troublesome situation in a manner that promises, over a period of time, to restore a solid base for sustained growth and stability.

In approaching that challenge, and in our preoccupation with what is wrong with the economy, we should not lose sight of the positive aspects of the current situation.

-- The U.S. economy has enjoyed a long and relatively strong economic recovery; more people are employed than ever before, over 10 million more than five years ago.

-- In the face of unprecedented inflation, and enormous new increases in energy prices, wage trends overall have not appreciably accelerated this year, reflecting, despite some disturbing exceptions, the discipline and good sense of Americans in general in accepting the need for restraint.

- As the rate of increase of energy prices moderates -- and it should, with responsible pricing behavior by producers in coming months -- there is a reasonable prospect that the overall inflation rate will soon decline.
- Investment activity, while restrained by uncertainties of inflation and by tax and regulatory constraints, has been relatively well maintained, even though it appears lower than consistent with our long-term needs.
- Economic activity abroad is being sustained; this should support the recent trend of substantial growth in U.S. exports and help to improve the overall U.S. current account position.
- More generally, the sizable imbalances among industrialized countries are being reduced; the substantial reduction -- even elimination -- of Japanese and German current account surpluses is particularly noteworthy.

I don't report these facts with any complacency. These actual and prospective achievements, and much more, will be jeopardized by a failure to come to grips with the home-grown inflationary pressures that have become so pervasive, that have led to speculative distortions, and that have undermined stability and order in the

American and the world economy. Dealing with the sources of inflation and instability is central to both the domestic and international objectives of the United States; as I see it, these objectives are firmly interconnected, and we will be successful in neither unless we can begin to move toward restoring a sense of stability in our economy.

In this setting, the recent actions by the Federal Reserve were designed to deal with the clear danger of a renewed outburst of destabilizing and inflationary speculative pressures -- a development that could only complicate and distort the present process of economic adjustment -- and at the same time to establish a stronger foundation for orderly and sustained growth. In one sense, the Federal Reserve actions announced on October 6 were part of a continuing effort to maintain control over money and credit expansion. Our basic targets were not changed. But the new measures, which involved among other things a change in operating procedures, should provide added assurance that those objectives will be reached. Above all, the new measures should make abundantly clear our unwillingness to finance a continuing inflationary process.

Specifically, in the period ahead, more emphasis will be placed on controlling the provision of reserves to the banking system -- which ultimately governs the supply of deposits and money -- to keep monetary growth within our established targets. We have raised the discount rate so that restraint on bank reserves will not be offset by excessive borrowing from the Federal Reserve

Banks. And we have placed a special marginal reserve requirement of 8 percent on increases in "managed liabilities" of larger banks (including U.S. agencies and branches of foreign banks) because that source of funds has financed much of the recent buildup in bank credit.

In connection with these Federal Reserve actions, I would like to emphasize several points.

First, as I suggested earlier, our immediate objective is to forestall speculative excesses and anticipations of a new inflationary outburst that could only complicate, and ultimately make more severe, the process of economic adjustment that is underway. In doing so, I believe that our recent actions can hasten, not postpone, the day when interest rates can decline and more stable conditions can be restored to credit and capital markets, thus providing part of the framework for renewed and stable economic growth. In the meantime, these actions are not intended to, and will not, cut off the supply of money and credit to the economy. Indeed, we are conscious of the fact that there are important areas of the economy -- home building, smaller businesses, and others -- that are particularly dependent on a continuing flow of credit. In that connection, we have asked the banks to take special care to avoid lending to support speculative activity, while giving particular attention to the continuing needs of their established customers for funds to maintain normal business operations.

Second, the doubts about the dollar in exchange markets in recent months have been one factor increasing uncertainties faced by businessmen and consumers alike. Given the dollar's central position in the international financial system, we must recognize that its external value is particularly sensitive to perceptions and expectations about economic policy, and especially to concern about our ability to deal with inflation. I see no fundamental conflict, indeed no meaningful "trade-off," between our domestic and international economic objectives in this respect. We continue, on a day-to-day basis, to monitor developments in foreign exchange markets, and if and when intervention is necessary, our actions will be closely coordinated with those of monetary authorities abroad.

Third, the recent Federal Reserve actions offer the promise that more effective control can be exercised over the growth of monetary aggregates, but they are not an automatic solution to all our difficulties. The new technique for conducting open market operations is not a panacea. The definition of money itself needs refinement, and redefinition of the monetary aggregates is currently a major Federal Reserve objective. We will be monitoring financial markets and the flow of credit closely. We will adapt our instruments to shifting needs as time passes, but we do intend to maintain the kind of restraint on monetary growth that this Committee and so many others have urged for so long.

Finally, we should not rely on monetary policy alone, critical as disciplined monetary policy is, to solve our economic problems. We also need a sustained, disciplined fiscal policy; we need an effective energy policy, commanding the support of all segments of our society, that will put us more surely in control of our destiny; we need regulatory and tax policies that will help stimulate investment, cut costs, and increase productivity; and we need international cooperation and understanding. At the IMF/World Bank meetings recently held in Belgrade, I was impressed again by the general understanding that rising real energy prices will require significant and painful economic adjustments and by the consensus on the need, under current circumstances, for virtually every country to attach high priority to the fight on inflation.

As has been amply reported, the atmosphere at those meetings was restrained, skeptical, and uneasy. Therein lies a danger. I am convinced that forceful and effective policies to deal with the evident problems can be successful. Those policies will need the support of concerned citizens who recognize the need for hard decisions, for restraint, and even for sacrifice. Pessimism and cynicism can only erode that process.

We are passing through a period beset with exceptional economic problems. Let us recognize there are risks, but that those risks will only increase if we fail to act forcibly to deal with inflation now, and if we fail to sustain the effort. That is the context in which the Federal Reserve has acted. I am convinced those actions, as part of a determined national effort, can help establish the essential conditions for a more prosperous and productive America, a strong dollar, and a sense of stability and coherence in the world economy.

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