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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 before this Committee today. In about three weeks, the Federal Reserve will submit its semi-annual monetary policy report to Congress. At that time, I will be reporting on the details of monetary policy, including the Federal Reserve's objectives for the growth of money and credit over the period ahead. This morning I will confine my statement to more general considerations of domestic and international economic policies within the context of recent and prospective developments.

The past year and a half has been a difficult period in the nation's economic history. Output has contracted, too much of our industrial capacity lies idle, and unemployment is far too high -- the highest since World War II. But as we enter the new year, there are encouraging signs that recessionary pressures in some key sectors are abating. Substantial progress has been made in reversing the inflationary trend of the past decade, and we can build on that progress. Of central importance to that outlook are signs that productivity may be growing more rapidly after a decade of increasingly unsatisfactory performance. Consequently, the stage appears set for sustainable recovery in business activity, bringing with it the higher levels of employment and real income that we all desire. The challenge for policy is to make that prospect a reality that can carry forward for many years.

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An important element in this improved outlook is the change in financial market conditions over the past year. Federal Reserve policy has been aimed at avoiding monetary excesses that would lead to resurgent inflation, while providing enough liquidity to meet the needs of economic growth. In the midst of rapidly changing economic and financial conditions, meeting this objective could not be a simple mechanical matter of adhering rigidly to a pre-set guideline for money and credit growth. At times in the past year there have been indications of unusual demands for highly liquid assets, evidently reflecting shifting preferences on the part of the public in an environment of uncertainty. Moreover, the monetary aggregates, particularly in the latter part of the year, have been distorted by a sequence of special developments -- most prominently, the maturing of All Saver Certificates and the introduction of new deposit instruments.

These and other influences resulted in extraordinary decreases in the observed velocity of money -- loosely speaking, the "turnover" of money balances. In fact, velocity has declined to an extent without precedent in the postwar period. We thus have had to approach monetary targeting and our operational decisions to provide reserves with greater elements of judgment and flexibility in the light of emerging developments. There has been a need to take account of the possibility that underlying trends in the relationship between measures of "money" and economic activity may be shifting as inflation and market interest rates decline while, to a greatly increased extent, market-oriented interest rates are paid on bank deposits. In the end,

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we accepted some "overshooting" of the ranges we set for monetary growth -- relatively small for the broader aggregates M2 and M3, and sizable for M1.

A number of factors, including the halving of the inflation rate during 1982 and the recession, contributed to substantial declines in nominal interest rates all along the maturity spectrum in the second half of the year. Short-term interest rates are now as much as 10 percentage points below their earlier peaks, and long-term rates are down 5 to 7 percentage points. Meanwhile, equity prices have risen sharply.

Lower interest rates for mortgages and -- to a lesser degree -- for installment credit have helped make the financing of purchases by households more affordable. At the same time, businesses could begin to improve their balance sheet positions. Bond issuance by nonfinancial corporations in recent months has more than tripled from levels in early 1982 as corporations have been refunding short-term debt.

Reflecting these developments, activity has been improving for some months in the credit-sensitive housing and consumer durables sectors of the economy. The most notable turnaround has been in real estate markets. Construction of new single-family homes is up a third from last summer's very low levels and sales of new and existing homes have climbed substantially. Housing activity is still, of course, well below earlier peak rates, and below what we would like

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to see over time in order to ensure that our growing population can be well housed; but the inventory of unsold new homes is quite low and the improved financial climate bodes well for further gains in this sector. With personal disposable income relatively well maintained, with some improvement in the liquidity and debt position of consumers, and with much more moderate price increases, consumer purchases of "big ticket" items also appear to be stabilizing or improving.

The short-term business outlook is often dominated by inventory adjustments, and 1983 may be no exception. Recalling the excesses of earlier recessions and faced with high borrowing charges, businesses made vigorous attempts to curtail the accumulation of unwanted stocks late last year. The process moved more unevenly over the summer as sales were disappointing, but picked up in the final quarter. Further liquidiation would restrain production growth in the months immediately ahead, but any sustained improvement in final demand could soon be reflected in more than proportionate increases in output.

As production begins rising, we are likely to see more substantial increases in productivity. In fact, productivity grew in 1982, unusual during a period of recession. Widely reported efforts of businessmen and workers to increase efficiency and reduce "breakeven" points should pay off more visibly during a period of expansion. Combined

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with continued moderation in nominal wage increases, such an increase in productivity would imply relatively modest increases in unit labor costs -- about two-thirds of all costs in the economy -- and thus prolong and reinforce the progress on inflation.

For the time being, with excess capacity large and profits depressed, business investment in new plant and equipment is likely to continue to fall. Some delay in the recovery of capital spending is not out of line with previous cyclical experience, as businesses initially boost operating rates for existing capital rather than invest in new plant and equipment. But it is critical to the long-run health of the economy that a recovery in business fixed investment not be postponed too long. Capital spending has a pivotal role in extending the length and durability of an economic expansion, and in improving productivity and living standards.

The outlook for business fixed investment is in good measure dependent upon renewed profits and recovery, but also on a sense that monetary and fiscal policies will succeed in fostering a more stable financial and economic climate over time. During a period of transition toward price stability, some investment plans based in part on expectations of rising prices may be cut back, particularly if financial market conditions are slow to reflect the progress toward stability. Cutbacks in some sectors of the energy industry in 1982 may be a case in point. One important factor affecting the

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financial climate and business confidence today is concern about federal budget deficits and their effects on the cost and availability of funds needed to finance private sector investment. This is a point I will return to later.

The deficit also contributes to uncertainty about whether the gains against inflation can be sustained. By all the various measures, prices rose by 5 percent or less last year, the slowest rate of increase in a decade. To be sure, part of that improvement reflected favorable food and energy price developments, abnormally low commodity prices generally, the effects of the sharp appreciation of the dollar, and more generally, the cyclical weakness of the economy. Obviously, we are still short of the goal of reasonable price stability. In fact, inflation is really only back to the pace of 1971, which was judged to be so intolerable at that time that wage and price controls were imposed, and the American people --habituated to high and rising rates of inflation for a decade -- remain skeptical about whether the progress will be lasting.

Unlike 1971, however -- in fact, unlike the entire decade of the seventies -- trends of underlying costs and inflation expectations are now moving in a favorable direction. I believe this improvement can be sustainable as the economy recovers its upward momentum. I alluded earlier to the favorable signs with respect to productivity. At the same

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time, increases in nominal wage and salary costs slowed to the 6-7 percent range -- a development that was fully consistent with maintaining real incomes of workers because price increases were slowing more rapidly than wages.

Clearly, the more restrained wage increases were directly related to the pressures in labor markets during the recession. Total employment fell. While layoffs were concentrated in the industrial sector of the economy, even the service-producing sector -- the primary source of employment growth in recent years -- experienced declining payrolls. The overall jobless rate reached a postwar high of nearly 11 percent in December, more than 3 percentage points above the rate that prevailed before the current contraction began.

Obviously, success in dealing with inflation cannot be based on an economy that stays in recession, with all the hardship and misery that implies. We need to maintain moderation in wage settlements and pricing policies as the economy expands. In the near term, the slack in the economy and the present momentum in wages and prices should be consistent with continuing restraint on unit labor costs. But sustained improvement will also depend on a sense of conviction that prices will remain under control, and on prospects for rising real income even as nominal income grows more slowly. Bargaining practices and attitudes -- built up during a period of accelerating inflation -- change only slowly, but surely success

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will fundamentally be dependent upon a sense that the financial environment will remain conducive to progress against inflation. The implications for both monetary and fiscal policy seem to me clear.

Other countries have been attempting to deal with some of the same basic problems that we have been facing. After a decade of inflation, subnormal economic performance has been pervasive, and unemployment in the industrialized world has risen to levels unprecedented in the postwar period. The abrupt and disturbing increases in oil prices have certainly been an important influence, first in aggravating the inflation, and then in the subsequent dislocation attendent upon the efforts of almost all countries to contain that inflation by restraining demand. But the stubborn inflationary pressures that arose in nearly all countries cannot be attributed to oil alone, and there was, de facto, a broad consensus that policies needed to be directed toward restoring stability.

While wide divergences remain among individual countries, striking progress has by now been made generally in achieving lower rates of inflation. But, at the same time, growth has essentially stopped, with real GNP in major foreign industrial countries showing no significant change on average last year (on a fourth-quarter to fourth-quarter basis). For most developing countries, there was an abrupt and substantial deceleration from the growth rates of recent years, from about

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4 to 5 percent in 1979-80 to an estimated 1-1/2 percent last year. In Latin America, growth apparently was negative.

There has been a substantial risk in this situation of recession feeding upon itself internationally and countries turning toward protectionism in an attempt to insulate their own industries. That approach would, of course, be self-defeating. As protectionist measures spread from one country to another, gains from reduced imports would be offset by closed export markets. At the same time, protectionist measures work directly against the competition necessary to restrain inflation. In the United States, as elsewhere, compromises have been made with protectionist pressures. Nonetheless, we can take some satisfaction from the fact that a liberal trading order has not broken down over all. Maintenance of that approach, which has been a cornerstone of our prosperity for a generation, seems to me critical to the outlook.

Our own vulnerability to weakness in international trade has been conclusively illustrated by events in 1982. The slowdown in business activity abroad, combined with a surge in the strength of the dollar relative to other currencies, has sharply curtailed our export opportunities -- and merchandise exports now account for some 16 percent of all U.S. goods output.

From the beginning of the dollar's upsurge in the fall of 1980 through November 1982, the average value of the

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dollar against other major currencies rose more than 40 percent; it has given up only a limited portion of that rise over the past couple of months. Some of that strength was a reflection of the progress against inflation, and greater confidence in the price outlook is, of course, healthy. The U.S. was also in a relatively strong current account position in 1980 and 1981 and continuing into the first half of 1982, when some other major countries were running large deficits. However, in 1982 the dollar may also have been unusually strengthened by more temporary, and even non-economic factors. For much of the period our interest rates were exceptionally high, and the apparent strength, stability, and security of the U.S. and of its financial system at a time of widespread financial pressures and political and economic uncertainty abroad played a role.

Under the combined impact of world recession and an exceptionally strong dollar, our export volume dropped about 15 percent from the fourth quarter of 1981 to the fourth quarter of 1982, considerably greater than the declines experienced by other industrial countries. While imports have also declined, the change was small. As a result, the decline in real U.S. exports of goods and services during the recession has been equal to nearly one-half of the total decline in U.S. GNP. In contrast to earlier periods of U.S. recession, when our trade balance generally improved thus tending to offset other areas

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of weakness, the export sector has been one of the major depressing influences on the U.S. economy. While the dollar has lost some of the earlier gains in recent months as our current account has moved into large deficit, the external sector is likely to remain a source of weakness for some time.

The simple fact is that the health of the international economy and our trading position are today highly important to our recovery and prosperity. The point is emphasized all the more by the sharply deteriorated financial position of several large developing countries, countries heavily indebted to commercial banks and other institutions in the industrialized world.

For several years, a number of large developing countries had been increasing their foreign debts at a pace that could not be sustained indefinitely, either from the standpoint of the rising debt service burden on the borrower or of the gradually increasing exposure relative to assets and capital of the lending banks. For a time, the heavy borrowing helped to sustain rapid internal growth in much of the developing world, but increasingly the need for adjustment to reduce internal pressures and balance of payments deficits became apparent. Some of the borrowers started that process some time ago, but with inadequate force and conviction.

The slowdown in world growth helped expose the increasingly precarious position of borrowers as prices of commodity exports fell, markets for manufactured goods weakened, and higher real interest rates increased their debt servicing

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requirements. The difficulties experienced by our Mexican neighbors -- the largest of the international borrowers -- in maintaining their debt payments last summer precipitated widespread public awareness and concern about the potential repercussions for the international financial system. The problems are not unique to Mexico, or to banks located in the United States. Without action to deal with these problems, the consequences could be harsh, not only for the borrowing countries but for their trading partners and for all countries dependent upon a smoothly functioning financial system. But the fact is vigorous efforts are underway to deal with the problem. With the active cooperation of the borrowers, the lenders, and the lending countries, they can be successfully resolved.

A basic element in any program must be strong actions by the borrowing countries themselves to restore internal and external equilibrium. It is particularly encouraging that a number of important developing countries have taken the significant step of negotiating comprehensive stabilization programs with the International Monetary Fund. Upon approving such a program, the IMF itself provides limited sums of medium-term financing; even more important, IMF imprimatur should reinforce the confidence of other lenders. In some instances, governments, acting bilaterally or through the Bank for International Settlements, have provided temporary financing to meet pressing liquidity needs as the IMF program is established.

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On that base, commercial banks have acted together in important instances to "roll over" existing indebtedness and to assure enough additional funding to permit time for orderly adjustment. Those efforts, involving hundreds of banks here and abroad, typically call for a reduced flow of new bank loans, commensurate with reduced payment deficits by the borrowers, and no increase in bank exposure relative to capital. Well conceived and constructed, the net result of the adjustment and refinancing programs should be to improve the credit-worthiness of the country concerned.

All of this emphasizes the key role of the IMF in the international financial system. But if the Fund is to play the strong role required, currently and prospectively, it is essential that it be able to look forward with confidence to enough resources to meet potential demands upon it. Much progress has been made in reaching an international consensus in the discussions about enlarging the resources of the IMF, and agreement on a substantial augmentation of those resources by means of increased IMF quotas and a broadened IMF borrowing arrangement is expected in February. That program will require legislative approval, and I believe timely action by the Congress is essential to assure that IMF resources are commensurate with possible needs and, more broadly, to demonstrate that governments can act together, decisively and effectively, to deal with potential threats to our prosperity arising from international debt problems. Conversely, failure to strengthen the international financial system could only feed back adversely on our own prospects for growth.

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All of this implies intense and continuing efforts by the borrowers to expand exports and reduce imports, with implications for the U.S. and other leading trading countries. Clearly, we cannot all increase exports and reduce imports together, and it is equally clear that the whole process will be -- and over time must be -- facilitated by renewed growth in the industrial world. As understated in the communique issued following the January 18 meeting of the Group of Ten, "a sustainable improvement in activity in the industrialized countries in 1983 can make an important contribution to a lasting solution of the indebtedness problem of many developing countries."

I would emphasize the word "sustainable" in that communique. A short-lived recovery, without staying power and accompanied by reignition of inflationary pressures, offers no real solution to our problems or those of developing countries.

It is in that context that I believe we need to approach domestic policy. There was a time when the American public felt confident about the ability of government to improve economic conditions. But long years of accelerating inflation and rising unemployment, instability in financial markets and the economy, and concern about burgeoning budgetary deficits have eroded that confidence. It can be restored, and I am convinced the economy can be returned to a path of sustained growth. But that effort must rest in part on a demonstrated commitment to disciplined financial policies.

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As we look ahead, and as the President has emphasized, the state of the Federal Budget, as it now stands under current law and policies, could undermine that effort. To be sure, a substantial part of the deficits in the 1982 and 1983 fiscal years -- certainly more than half -- reflects the impact of current business conditions on the budget. Those cyclically induced deficits are not my main concern -- indeed they currently help support spendable income and buoy the economy.

In the past as the economy recovered, the cyclical component of the deficit would diminish and the budget would move toward balance. What is unprecedented about the current situation -- and is of great concern -- is that even as revenues benefit from an expanding economy over the coming years, we will still face continuing sizable deficits unless significant action is taken.

There can be disagreement about the precise size of the prospective deficits; what does seem beyond dispute is that little improvement, if any, in the budgetary position will develop under current law and policies even with a strong and continuing recovery. A number of the proposals of the President in his State of the Union address were, of course, directed toward this problem.

Left unattended, the situation would pose a strong potential for a clash between the need to finance the deficit and the rising financial requirements for housing and the business investment that is crucial to a healthy recovery.

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In the end, all those needs have to be met out of saving, and there simply isn't enough to go around. The Federal Government will have to bid funds away from potential private borrowers, and the higher real interest rates that result will work against growth in private investment and housing.

It's not just a problem for the future. The perception that there is a major structural imbalance between our spending programs and our revenue base affects financial markets today. Lenders, fearful of renewed inflation and the high interest rates that budget deficits would produce in a growing economy, are more reluctant to commit funds for a long period of time now. The sensitivity extends beyond financial markets because inflationary concerns affect the climate of wage bargaining and pricing policies.

It is tempting to suggest that the budget problem and its consequences for the performance of the economy could be solved by monetary policy. But excessive money and credit creation to meet the needs of the Government would only risk adding to the uncertainty about future inflation and interest rates. In the end, nothing real would be gained, while hard-fought ground in the battle against inflation would be jeopardized.

Certainly a better fiscal outlook -- with all it implies -- would provide a better environment for the conduct of monetary policy, relieving concern about the longer-term implications of every twist and turn in the monetary aggregates or short-term policy actions. But as things stand, fear of growing

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deficits clouds the future and contributes to market pressures and inflationary uncertainties, adding to the burdens on monetary policy. Conversely, meaningful action to demonstrate the Government's economic discipline on the fiscal side would reinforce confidence that monetary policy over the years ahead can do its job, without intolerable market pressures, in maintaining a course consistent with price stability.

As I indicated at the outset, I will be able to deal more specifically with our targets for the growth of money and credit after the Federal Open Market Committee, in the normal course, meets in early February to adopt guidelines for the coming year. In approaching those specifics, we are, and will continue to be, concerned with maintaining a monetary environment consistent both with continuing progress against inflation and with lasting expansion. Reconciling those goals, at a time when institutional and economic factors have called into question the reliability of past relationships between money and the economy will be a difficult and delicate job. The approach cannot be reduced to an arithmetic, or econometric, formula, nor can success be achieved by monetary policy alone. But I am also convinced that those goals of growth and stability are not inconsistent as we look ahead in 1983. Indeed, I believe that neglect of one of them would, sooner or later, jeopardize the other.

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I am also acutely aware that the recent gains against inflation have been achieved in a context of serious economic hardship. The present state of affairs must not continue. Millions of workers are unemployed, many businesses are hard-pressed to maintain profitability, and business bankruptcies are at a postwar high. But in coping with inflation I also firmly believe we have laid much of the foundation for a long period of non-inflationary economic expansion. Only by building on that effort can we realize the true potential of the American economy.

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