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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 once again before the Joint Economic Committee. As you know, the Federal Reserve submitted to the Congress last week its semi-annual report required under the Humphrey-Hawkins Act, which reviewed economic developments and the decisions of the Federal Open market Committee with respect to monetary and credit targets for 1984 and 1985. My prepared remarks this morning, therefore, will be brief and confined to more general considerations of monetary policy in the context of our overall economic performance and the problems that present evident risks to an otherwise positive outlook.

The Overall Economic Performance

Measures of aggregate economic activity, employment, costs, and prices have provided an almost unbroken string of favorable news so far in 1984. The process of recovery from the deep and prolonged recession--a recovery that began amid widespread doubts about both its potential vigor and staying power--had proceeded strongly through 1983. There were widespread anticipations early this year that, as we moved beyond the initial recovery into a new expansion phase, the pace of growth would slow. But, in fact, growth actually accelerated as we moved into this year. During the first half of 1984, the economy as a whole grew at nearly a 9 percent annual rate, compared with a 6-1/2 percent pace during 1983. In addition, almost three million more people have been employed so far this year, bringing the total gains over the past 18 months close to 7 million, and the unemployment rate has dropped to about 7 percent.

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Much of the strength in economic activity this year has come from consumer spending, as unit auto sales in the first half rose to the highest level since mid-1979. With real income growth strong and consumer confidence high, the demand for other big ticket items -- such as furniture and appliances -- also has been robust. In the business sector, sales and profits have been rising rapidly, prompting a vigorous expansion in outlays for new plant and, particularly, equipment. The widespread need for acquiring new electronic and data processing technologies has continued to provide an element of strong demand for investment in capital goods. Potentially, this investment will be reflected in rising productivity, although the extent to which the trend of productivity growth is rising faster than during the late 1970's is still not clear.

Despite the surprising strength of activity this year, inflationary pressures (as measured by most summary price measures) have to this point remained subdued. In fact, a number of sensitive commodity prices have dropped recently, following sizable cyclical increases. Highly competitive domestic and international markets, influenced by the strength of the dollar overseas and continued strong efforts to discipline costs, have been key factors contributing to greater price stability. The net result has been rising productivity and good gains in real income, even while increases in nominal wage rates have remained moderate.

Looking only at these overall measures, this recovery and expansion period has been atypical -- atypical in the sense that rapid expansion has been maintained longer after the recession

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trough than in any comparable cyclical period since World War II, excepting only the Korean War episode. But the period has been atypical in other ways as well -- in ways that potentially will have severely adverse implications unless dealt with by timely and effective policy action.

Imbalances and Strains

In any period of recovery and expansion, some sectors fare relatively better or worse than others, and in that general respect this period has been no exception. What is different, in degree and in kind, is that some inevitable unevenness in patterns of growth in particular sectors has been aggravated by the massive and related imbalances in both our fiscal position and our international trading accounts and by some strains in financial markets.

As you know, rapid growth has been reflected in some reduction in the budgetary deficit, estimated for fiscal 1984 in the neighborhood of $170-$175 billion. The Congress is in the process of enacting the so-called "downpayment" against future deficits, part of which has already been signed by the President. But the hard fact is, as I am sure the Congress is fully aware, the deficit remains huge in absolute and relative terms. Absent further action, little or no further decline now seems probable for 1985 and beyond. Indeed, we cannot rule out that the deficit could be higher next year, even assuming the economy continues to move toward "full employment" levels.

That circumstance has been reflected in continued large Treasury borrowings, and expectations of indefinite continuation. Meanwhile, private credit demands, responding to and supporting

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growth in consumption and investment, have accelerated. But the sources of domestic funds supplied to credit markets have fallen far below our combined public and private demands for credit. In these circumstances, interest rates -- already historically high -- tended to move still higher during the spring.

Those high interest rates, combined with favorable economic conditions generally in this country, have attracted more and more capital from abroad to help meet our domestic financing needs, and the dollar has appreciated despite deterioration in our trade and current accounts. The strong dollar certainly has been a potent force helping to contain inflation and reduce pressures on our financial markets. But what is in question is the sustainability of that process as the United States becomes more and more dependent on foreign capital, as our export and import-competing industries are damaged and seek protectionist relief, and as interest rate pressures remain strong. In that sense, we are literally living on borrowed time.

The continuing difficulties of some heavily indebted developing countries in Latin America, and in some other places as well, has been another point of uncertainty. A sense of greater concern has, ironically, come at a time when several of the largest borrowers have more clearly made substantial progress toward reducing external financing requirements and toward carrying out the more fundamental adjustments that should provide a firm base for their renewed growth.

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That sense of concern has been related importantly to both the increases in interest rates over the spring, and to fears of protectionist measures damaging the capabilities of the indebted countries to export. Put another way, the related deficits -- budgetary and trade -- place heavy pressure on the international financial and trading systems -- pressures that can only be dealt with by attacking the source of the problem.

Within the United States, the relatively high level of interest rates has aggravated financial strains in the farm sector. Many thrift institutions face the prospect of weak earnings at a time when capital positions have been eroded by losses earlier in the decade. And, despite the rapid growth of the economy and strong increases in business profitability overall, more stable prices have exposed some weaknesses in credit practices of banks and others in the energy and other areas encouraged by earlier inflationary expectations.

Monetary Policy

These developments have provided the setting for the implementation of monetary policy thus far in 1984 and for the review of monetary and credit objectives by the Federal Open Market Committee for this year and next.

In reaching its policy judgments, the Committee members shared the widespread view that the overall rate of economic growth would moderate soon, as resources become more fully employed, and would continue through 1985 at a sustainable pace. While the rate of price increase has been somewhat slower than expected

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over the first half of 1984, that rate is generally expected to rise by a percentage point or so next year, assuming that the dollar remains in the same general range as over the past year. In making those projections, which are detailed in Table I attached, Committee members also noted that the continued high budget deficits and other factors noted earlier, unless dealt with effectively, would pose substantial risks of less satisfactory results with respect to economic activity or prices or both. In that sense, the projections should not be taken to assume that satisfactory results are assured, absent policy adjustments.

The economic projections, of course, took account of the decisions made on monetary policy. Broadly, monetary policy will remain directed toward providing enough money to support sustainable growth while continuing to encourage greater price stability over time. As detailed in the full report, Committee members felt that broad objective was consistent with the growth ranges for money and credit specified in February for this year, and no changes were made. For 1985, the tentative decision was reached to reduce the ranges slightly for both M1 and M2, specifically by lowering the top end of the ranges specified for this year by 1% and 1/2%, respectively. The target range for M3 and the monitoring range for domestic credit were left unchanged. These tentative decisions for 1985, reflected in Table II attached, will be carefully reviewed at the start of next year.

The Committee also reviewed the relative weights to be placed upon the monetary aggregates, and felt that roughly equal weight should be given each of them in implementing policy. However,

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appraisal of their movements, and relationships among them, will continue to be judged in light of developments with respect to the economy, domestic and international financial markets, and price pressures.

Although both M1 and M2 have grown within their targeted ranges this year, M3 and particularly domestic credit, have expanded faster than anticipated. Credit growth has, in fact, continued to outpace that of nominal GNP, as was the case last year but contrary to longer-term trends. Growth in the business component of nonfinancial credit has been amplified by an unusual spate of merger actvity and corporate financial reorganizations -- so-called "leveraged buy-outs" -- that had the effect of substituting debt for equity. The implications of those financings, while potentially adverse from the standpoint of the overall financial strength of particular businesses, are relatively neutral from the standpoint of demands on real resources and overall credit market conditions. Estimated adjustments for that activity on the rate of overall credit growth would reduce the indicated expansion over the first half of the year from a rate of about 13 percent to 12 percent, closer to, but still above, the monitoring range. That growth, together with the extraordinary rise in consumer and federal government debt, is shown in Table III.

In implementing the policies reflected in the various targets, steps were taken during the late winter and early spring to increase somewhat pressures on bank reserve positions, and the discount rate was raised once, from 8-1/2 to 9 percent. Reserve

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pressures have not changed appreciably since that time, as reflected in relatively unchanged borrowings at the discount window (apart from those by the troubled Continental Illinois Bank). With both M1 and M2 remaining within their target ranges, and against the background of the economic, price, and financial market developments reviewed earlier, stronger restraining actions on money and credit growth generally have not appeared appropriate. At the same time, the relatively rapid rates of growth in M3 and domestic credit are flashing cautionary signals.

While pressures on bank reserves did not increase further, both long- and short-term interest rates rose over the spring. The continued heavy credit demands, expectations that those demands would persist against the background of the huge federal deficit and strong economic expansion, and fears of a resurgence of inflationary pressures as both labor and capital are more fully employed all played a part. In more recent weeks, rates have tended to stabilize at high levels, perhaps partly because current price trends have, at least so far, not borne out more extreme inflationary concerns expressed earlier. Nonetheless, markets remain volatile and apprehensive.

Banking Markets

The atmosphere surrounding credit and banking markets at times during recent months has been appreciably influenced by the apparent difficulties of one of the nation's largest banks and by continuing concerns over the ability of some developing

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countries to service debts held mainly by large commercial banks around the world.

As I have reported to the Congress before, orderly and full resolution of the latter problem will require a strong cooperative effort by borrowers and lenders alike over a considerable period of time. As I noted a few minutes ago, the difficult process of internal and external adjustment is beginning to bear fruit in important countries in Latin America, including Mexico, Venezuela and Brazil. In other countries the adjustment process is less advanced, but the progress of some, both in adjustment and financing, can point the way for others. While the challenge for all remains substantial, with effort on all sides, the problem is manageable.

Recent concerns about strains on our banking institutions have focused on the problems of Continental Bank. That situation is unique for a large bank, but the episode may be an object lesson for all of us concerned with maintaining the strength of the financial system. In a period of rapid economic expansion, there can be temptations to relax credit standards in an effort to maximize growth. Bank managers need to appraise the risks prudently, taking full account of the possibility of a more adverse economic and interest rate environment. That, of course, is and should be the customary policy of banks, and I sense that some have reviewed their practices to make sure they are appropriate in today's circumstances.

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Conclusion

Indicators of overall economic performance have been exceptionally favorable for more than a year. So far, a strong economic expansion has been consistent with better price performance than we have enjoyed for many years.

At the same time, there are obvious strains, imbalances, and risks that could undercut much of what has been achieved. The only real question is whether we as a nation will deal with them promptly and forcefully with constructive public policies, consistent with long-term growth and stability, or whether we will be content, despite all the strains and dangers, to let events simply take their course. Short-sighted relapses into lack of financial discipline, widespread protectionism, and wage and pricing excesses could only aggravate the situation.

None of these problems will be cured by attempts to drive interest rates down artificially by excessive money creation; the inflationary repercussions could only aggravate the situation. Nor can distortions arising from other sources be dealt with effectively by any general monetary measures.

It is, in the end, the choice between building on the enormous progress of the past to achieve sustained growth in a framework of greater stability or a relapse into inflationary economic malaise. With that choice clear, I am confident that the needed policies are well within our collective grasp.

In the areas of our responsibility -- both monetary and supervisory policies -- we are working toward achieving stability and growth. We count on progress in other directions as well.

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The facts with respect to growth and inflation for more than a year demonstrate that we all have much upon which to build. But there are also clear signals that -- far from basking in the warmth of past and present progress -- we must undertake the strongest kind of effort to convert potential success into sustained growth and stability.

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Table I

Economic Projections for 1984 and 1985*

	FOMC Members and other FRB Presidents	
	Range	Central Tendency
1984		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	9-1/2 to 11-1/2	10-1/2 to 11
Real GNP	6 to 7	6-1/4 to 6-3/4
Implicit deflator for GNP	3-1/4 to 4-1/2	4 to 4-1/2
Average level in the fourth quarter, percent:		
Unemployment rate	6-1/2 to 7-1/4	6-3/4 to 7
1985		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	6-3/4 to 9-1/2	8 to 9
Real GNP	2 to 4	3 to 3-1/4
Implicit deflator for GNP	3-1/2 to 6-1/2	5-1/4 to 5-1/2
Average level in the fourth quarter, percent:		
Unemployment rate	6-1/4 to 7-1/4	6-1/2 to 7

*The Administration has yet to publish its Mid-session Budget Review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals is not included in this report.

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Table II

Growth Ranges Reconfirmed for 1984 for Money and Debt Compared with Actual Growth through June '84

	Ranges	Actual Growth QIV '83 to June '84
M1	4 to 8	7.5
M2	6 to 9	7.0
M3	6 to 9	9.7
Debt[1/]	8 to 11	13.1[e/]

Note: Growth ranges pertain to period from QIV '83 to QIV '84.

e/ Estimated.

Tentative Growth Ranges Adopted for 1985

M1	4 to 7
M2	6 to 8-1/2
M3	6 to 9
Debt[1/]	8 to 11

Note: Growth ranges pertain to period from QIV '84 to QIV '85.

1/ Domestic nonfinancial sector debt.

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Table III

GROWTH IN DOMESTIC NONFINANCIAL DEBT
(Seasonally adjusted annual rates, percent)

	QIV: 1983 to QII: 1984 1/
Total	13.1 2/
Federal	14.6
Other	12.6
Selected Categories	
Home Mortgages	11.7
Consumer Credit	18.4
Short-term Business Borrowing	15.6

1/ Based on quarterly average flow of funds data. QII: 1984 partly estimated.

2/ Adjusted for the credit used in corporate mergers and buyouts, it is estimated that growth in domestic non-financial debt would be about 12 percent (SAAR) over the first half of 1984.

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