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Testimony by

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before the

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I appreciate this opportunity to review once again with this Committee the conduct of monetary policy against the background of economic and financial developments here and abroad. As usual, a more detailed review of last year, of the prospective ranges for monetary and credit growth established by the Federal Open Market Committee, and of the Committee's projections for economic activity and inflation are set out in the Board's formal Humphrey-Hawkins Report delivered to you earlier. This morning, I want to concentrate on more general considerations underlying the policy approaches of the Federal Reserve. I will emphasize particularly how those approaches must fit into a broader pattern of complementary action both in the United States and in other countries if the common objective of sustained economic expansion and price stability is to be reached.

The Economic Setting

The current economic expansion -- now extending into its fifth year -- is already among the longest in peacetime history. It is unusual in other respects as well, including the absence of certain signs of cyclical excesses that often develop after years of expansion. For instance, inventories have been held well within past relationships to sales, and spending by manufacturers for plant and equipment has, if anything, been restrained relative to prospective needs.

While the overall rate of economic growth has been rather moderate since mid-1984, averaging about 2-1/2 percent a year, that growth has been maintained despite strong pressures

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on sizable sectors of the economy. Oil exploration and development activity and agricultural prices have both been heavily affected by worldwide surpluses. Commercial construction in many areas is suffering from earlier over-building. Regions of the country in which those impacts have been particularly large have thus remained relatively depressed. Difficult as those regional conditions have been, however, many of the necessary adjustments are well advanced and other areas of the economy have been moving strongly ahead.

More importantly, both the inflation rate and interest rates, after four years of expansion, are substantially lower than when the recovery started. Homebuilding is being well maintained, and both capital and labor appear available to support further growth for some time without undue strain on resources. Certainly, conditions in financial markets, with stock prices exuberant and interest rates generally as low as at any time since the mid-1970s, appear supportive of new investment.

But if the traditional indicators of cyclical problems are largely absent, it is also evident that the economy is struggling with structural distortions and imbalances that, for us, have little precedent. Economic activity over the past two years has been supported very largely by consumption. That has been at the expense of reduced personal saving rates that, by world standards, were already chronically low. At the same time, the huge federal deficit is absorbing a disproportionate amount of our limited savings.

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For a time, we have largely escaped the adverse consequences for financial markets of that insidious combination of low saving rates and high federal deficits by drawing on capital from abroad -- the flow of which in 1986 actually exceeded all the savings by U.S. households. The other side of that coin, however, is a massive trade and current account deficit, restraining growth in manufacturing generally and incentives for the industrial investment that we will need in the years ahead.

The simple facts are that we are spending more than we produce and that we are unable to finance at home both our investme needs and the federal deficit. Those are not conditions that are sustainable for long -- not when, as at present, the influx of capi from abroad cannot be traced to a surge in productive investment.

It's not sustainable from an economic perspective to pile up foreign debts while failing to make the investment that we need both to generate growth and to earn the money to service the debts.

It is not supportable politically, as the pressures on our industrial base are transmuted into demands for protection.

Ultimately it will not be supportable from an international perspective either, as the confidence that underlies the flow of foreign savings will be eroded.

Sooner or later, the process will stop. The only question is how.

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The Broad Policy Approach

In concept, we could shut off the flow of imports by aggressive, broadbrush protectionist measures. But the result would be to drive up the rate of inflation and interest rates here, to damage growth abroad, and to invite retaliation. Instead of sustained and orderly growth, we would invite world-wide recession.

We could try to drive the dollar much lower -- or complacently sit back while the market forces produce that result. But that too would undermine the hard-won gains against inflation, and would risk dissipating the flow of foreign capital we, for the time being, need. The stability of financial markets would be jeopardized, and export prospects could be undercut by adverse effects on growth abroad.

Faced with similar circumstances, many smaller countries might reasonably embark upon strong austerity programs -- indeed sooner or later would be forced to undertake such programs. Large doses of fiscal and monetary restraint would be taken, risking recession in the short run, but also anticipating that exports would respond vigorously, imports would decline, and their economies would soon resume growth on a much sounder footing. But, in the context of a sluggish growth of the world economy, for the United States to take that course would entail particularly high risks and the results would be problematical at best.

There is a reasonable alternative. It is more complicated, but at the same time much more promising.

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We can draw upon a combination of policy instruments to encourage the needed adjustments. Results may take time. But those results will come with greater certainty -- and they should be consistent with maintaining growth here and abroad, with progress toward underlying price stability, and with open markets.

That is, in fact, the course on which we are embarked. To be sure, its success will require an unusual combination of discipline, patience, and international cooperation. However, given the stakes not just for the United States but for others, I don't think there is any real choice.

Important steps have already been taken in the needed directions. Most obviously, the value of the dollar vis-a-vis the currencies of other industrialized countries has declined substantially, placing our industry in a much stronger competitive position. The volume of exports is rising, despite relatively slow growth abroad. The deterioration in the trade deficit overall appears to have been stemmed, even if clear evidence of a reversal is still lacking. Moreover, while the depreciation of the dollar inevitably carries in its train rising import prices, we have been fortunate that the initial impact on the overall price level was more than offset by falling oil and other commodity prices. The underlying inflation rate, measured by trends in wages relative to productivity, has continued to fall.

We have also been fortunate that the flow of capital from abroad, buoyed by the rising stock and bond markets here and by some declines in interest rates abroad, has been well

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maintained as the dollar depreciated. Nevertheless, as we succeed in reducing our current account deficit, the net capital inflow will decline as well. That emphasizes the critical importance of moving ahead with further reductions in the federal budget deficit which absorbs so much of our own savings.

The progress being made in that direction this year is heartening. But that can only be a start. The projected reduction of $40 to $50 billion this year is from a record high deficit of more than $220 billion in fiscal 1986 -- more than 5 percent of the GNP -- and it is being assisted by some temporary factors. Progress next year will be harder.

Success in my mind will not be measured so much by whether we meet some pre-ordained arbitrary target but by whether in fact a reasonably steady downward pace in the deficit is maintained as the economy grows -- and maintained by measures that can be sustained, year after year. Failing that, it's hard to see how a sustained decline in the trade deficit, if possible at all in the face of huge budget deficits, will bring net benefit to the economy. The clear implication would be congested capital markets, higher interest rates, strong inflationary dangers, and threats to growth.

International Consistency

Inevitably, because we loom so large in the world economy, marked improvement in our trade balance will be matched by noticeable deterioration elsewhere. Appropriately, that should take place largely in the major countries with exceptionally large surpluses -- notably Japan and Germany,

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both of which are now experiencing some decline in _real_ net exports. That process cannot take place smoothly and effectively unless those countries and others are able to maintain a strong momentum of _internal_ demand.

For years, those countries have been dependent for growth mainly on high and rising export surpluses. In both instances, some shift toward domestic demand was apparent in 1986, encouraged partly by some relaxation of monetary policies. That points in the needed direction. But there are also signs that their growth, overall, may be faltering, as exports have declined. At the same time, relatively high levels of unemployment and unused capacity, together with sharp appreciation of their currencies, offer substantial protection against a resurgence of inflationary pressures that they, understandably, want to avoid.

Quite obviously, the needed reorientation of economic policies -- essentially the complement of our own -- is no easier to achieve in those countries than here. Certainly, the nature and design of the needed measures will be -- indeed is being -- strongly debated within those countries. What is critical from a world perspective is not the precise nature of the measures or their exact timing, but that, at the end of the day, they are successful in maintaining a strong momentum of growth even as they absorb more imports from the rest of the world.

One danger is that, in the absence of stronger domestic growth, pressures will intensify for more appreciation of their currencies, undercutting further their own economic prospects.

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Given the size of the exchange rate adjustments already made, greater instability in that area seems neither in their interest nor ours.

Some newly industrialized countries also have clear responsibilities for contributing to a better world balance. Taiwan and Korea, in particular, have or are building external surpluses that are large even by the standards of the traditional industrial powers. Part of that reflects a strong competitive position, but both also maintain a strong wall of protectionist barriers. The very strength of their external positions points -- in the interests of their own citizens as consumers, as well as of world equilibrium -- to the need for more forceful action to increase imports, whether by reducing tariffs, by lifting other trade restrictions or by exchange rate changes.

Success in these efforts, I must emphasize, will not necessarily or primarily be measured by changes in our own bilateral trade vis-a-vis particular countries. An open competitive trading order is by its nature multilateral, and we and others should judge equilibrium in a world-wide context.

In that connection, most of the developing world, already carrying heavy debt burdens, is in no position to revalue currencies or to absorb much higher imports (from the United States or from others) <u>without</u> more or less parallel increases in their exports. In recent years, however, it has been the United States that has, in fact, absorbed the great bulk of what increase in exports Latin America has had -- their

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exports to Europe and Japan have apparently increased little if at all.

For us to close our markets to them now would assuredly thwart prospects for expansion, and with it the encouraging progress that has been made toward both more open, competitive economies and political democracy. What is needed instead is greater access by those countries to growing markets in Europe and Japan as well as here. The recent changes in exchange rates in the industrial world certainly provide greater incentives for exports of the developing countries to shift to Europe and Japan. At the same time, imports by the developing world from the United States have become much more price competitive than a year or two ago.

The Debt Situation

I cannot neglect emphasizing one further continuing threat to growth and financial stability involving the developing countries. Management of the debt problems of Latin America and some other developing countries is again at a critical stage. The reason is not that progress is absent. To the contrary, most of the heavily indebted countries have been growing -- if for the most part far below their potential -- debt burdens are tending to move lower relative to exports or other measures of capacity to pay, and new financing needs have been reduced. Perhaps most encouraging, there has been definite, if sometimes hesitant, progress toward liberalizing trade, opening markets, and reducing internal economic distortions, with the World Bank playing a particularly helpful role.

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At the same time, any failure of the industrialized countries collectively to achieve a satisfactory rate of growth would clearly impair prospects for the developing countries to find the markets they need. More immediately, in recent months, the process of reaching agreement on adequately supportive and timely financing programs, whether by restructuring existing debts or by arranging what new loans are necessary, has conspicuously slowed.

In their particulars, the reasons are as varied as the complexity of the individual financing programs themselves, most of which require the agreement of hundreds of banks around the world. In some instances, policy set-backs in the borrowing countries have complicated the task. But I also suspect the very fact that progress has been made over the past five years -- most evidently in reducing the exposure of banks relative to capital to something like half of what it was in 1982 -- has had the unfortunate effect of dulling a sense of urgency and cooperation by some. I do not want to deny the progress. But to fail to carry through on past efforts now would plainly jeopardize much of that success and threaten new strains on the financial system.

Implications for U.S. Policy

Several key implications of all this for the United States should be clear.

First, the process of restoring external balance requires first of all that we tend to our inescapable responsibilities to deal with our budget deficit. That is not just because we are dangerously dependent on foreign savings but because progress abroad is, as a practical matter, likely to be stymied without constructive leadership from the largest and strongest nation.

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Should we instead resort to closing our markets, be indifferent to depreciation of our own currency, and permit inflationary forces to regain the upper hand, then there would be no basis for confidence in the United States. Prospects for effective complementary action abroad, or for growth for the world economy, would be dim indeed.

Second, we have to recognize that the needed adjustments will require a relative shift of financial and real resources into internationally competitive industry and away from consumption and federal deficits. Without a sharp rise in overall productivity from the one percent or so rate characteristic of most of the 1970s and 1980s -- and I see no reason to suggest that trend will change abruptly -- the recent rate of increase in consumption is simply unsustainable for long. Instead, more of our growth will need to be reflected in net exports and business investment, and less savings will be available to finance government.

Fortunately, performance with respect to productivity growth and restraint on costs in the key manufacturing sectors has been relatively strong during the period of economic expansion. That reinforces prospects for a stronger competitive position internationally. The challenge will be to maintain that performance in the face of a depreciated currency, higher import prices, and more sizable needs for new investment to meet domestic and export opportunities.

Finally, achieving these goals in the context of sustained growth and reasonable price stability is beyond the capacity of any single policy instrument. Quite obviously,

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monetary policy will have a critical role to play. In doing so, it has the potential advantage of more flexibility than other policy instruments. But there will also be a heavy premium on maintaining discipline and sound judgment amid potentially conflicting criteria.

Rapid Growth of Money and Liquidity

Throughout 1986, monetary policy accommodated a relatively rapid growth in the various monetary aggregates; the narrowly measured money supply -- M1 -- grew at a particularly rapid pace. The discount rate was reduced four times by a total of 2 percentage points, more or less in line with reductions in market interest rates. The degree of reserve pressures, measured by average adjustment borrowings of depository institutions from the Federal Reserve, was relatively low throughout 1986, and has remained so since.

This generous provision of reserves and expansion in money took place in, and appeared justified by, an environment of restrained economic growth and declining inflationary pressures. The latter, to be sure, was dramatically and importantly reinforced by a temporary factor -- the sudden collapse in the price of the world's most important commodity, oil. But, potentially more lasting indicators of inflationary pressure -- the rate of increase in workers' compensation and in prices of some services that respond slowly to changes in the economic environment -- were also trending downward. For much of the year, most commodity prices other than oil, measured in dollars, were falling despite the depreciation of

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the dollar in the exchange markets. Moreover, the sizable declines in long-term interest rates seemed to reflect some easing of fears of a resurgence of inflationary pressures in the future.

Nonetheless, the possibility of renewed inflation remains of concern both in the markets and within the Federal Reserve. One potential channel for renewed inflationary pressures would be an excessive fall of the dollar in the exchange markets. At times during the past year, such exchange rate considerations prompted particular caution in the conduct of policy. The timing of operational decisions with respect to the discount rate or the provision of reserves was affected; on occasion close coordination with the actions of other central banks was particularly important.

More generally, intensive analytic work during the year suggested that much of the relatively rapid growth in the various monetary aggregates was closely related (with lags) to the rather sharp declines in market interest rates late in 1985 and the early months of 1986. The responsiveness of money demand to changes in interest rates is a well established phenomenon. What is new in the present institutional setting is the increased sensitivity of that relationship, most particularly for M1. Today, interest rates paid on transactions accounts widely used by individuals are close to rates paid on competing financial instruments. That is because interest rates on those accounts have not declined nearly as much as market rates or those on longer-term deposit accounts. Consequently, there

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has been a strong incentive to transfer funds to NOW (and to some extent savings) accounts and away from other, less liquid instruments.

Demand deposits, which are largely held by businesses and pay no interest, also grew substantially more rapidly than in earlier years. In part, that was also a reflection of declining market rates; banks demanded larger balances in compensation for services provided businesses, and depositors found alternative uses of liquid balances relatively less attractive.

Because of its composition, M1 was particularly influenced by these shifts and grew by 15 percent. That was far in excess of the target set at the start of the year (when the Federal Open Market Committee drew attention to the uncertainties surrounding that aggregate) and above any postwar historical experience as well.

Both M2 and M3 ended the year within -- but just within -- their target ranges. Even so, the increases of almost 9 percent were about as large as most earlier years, when inflation and the rate of economic growth were higher.

With inflation down and real growth moderate, these rapid increases in monetary growth meant that all measures of velocity (i.e., the ratio of nominal GNP to money) declined. That was particularly evident in the case of M1; the velocity decline of 9 percent was greater than in any year since World War II.

While velocity often moves erratically in the short run and a decline is typical of periods of falling interest rates,

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last year extended and amplified a pattern that has persisted since interest rates peaked in 1981 and 1982. The earlier post-war upward trend in M1 velocity of about 3 percent a year -- a trend established during a period of generally rising inflation and interest rates -- clearly does not provide a reasonable base for judging appropriate M1 growth today. Historically, there has been little or no trend in M2 velocity. Even so the current level is historically a bit low relative to other periods of low or declining interest rates.

All of this poses new questions in setting monetary targets to help guide the conduct of monetary policy. In the broadest terms, a levelling, and even some decline, in velocity could be welcomed as an appropriate sign of growing confidence in the value of holding money during a period of disinflation. But explanations revolving around declining interest rates and greater confidence in price stability beg the larger issue.

Not all the increases in money can be adequately explained by interest rate relationships, nor can we be certain about what interest rate is appropriate. Confidence is hard to win and easy to lose. We need to be conscious of the fact that the effects of excessive money creation on inflation may only be evident with lags -- possibly quite long.

As a consequence, we cannot avoid relying upon a large element of judgment in deciding what, considering all the prevailing circumstances, money growth is appropriate.

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Obviously, so far as 1986 is concerned, the FOMC made the judgment that relatively strong growth in the aggregates, and particularly M1, could be accommodated consistent with the more basic objectives of orderly growth and price stability. Neither the rate of economic growth, nor the margins of available resources, nor underlying cost trends, nor the movement of sensitive commodity prices suggested money growth was setting in train renewed inflationary forces.

The continuing rapid rate of debt throughout the economy -- running far above the rate of economic growth since 1982 -- has raised one warning flag. In one sense, the enormous volume of purely financial activity, especially at year end but also at times earlier, reinforced other factors increasing the demand for money. But from another point of view, the ready availability of reserves and money was also a factor facilitating that same increase in financial activity.

The implicit dangers should be clear. More leveraging of corporations, aggressive lending to consumers already laboring under heavy debt burdens, and less equity in homes all increase the vulnerability of the economy to economic risk -- to higher interest rates, to recession, or to both. The fact that, after four years of expansion, many measures of credit quality are tending to deteriorate rather than improve, and that too many depository institutions are strained, should be warning enough.

Restraining more speculative uses of credit by more restrictive monetary policy is, of course, possible. But that blunt approach inevitably has implications for all credit and for

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the real econony as well as financial activity. It cannot substitute for prudent appreciation of the risks in highly aggressive lending by those engaged in financial markets, reinforced and encouraged by regulatory and supervisory approaches sensitive to the potential problems.

The Approach to 1987

In evaluating this experience, the Committee remains highly conscious of the long historical patterns that relate high rates of monetary growth over time to inflation. Consequently, in approaching 1987, it starts with the strong presumption that such growth should be moderated. Reflecting that intent, the tentative target ranges for M2 and M3 set out last July of 5-1/2 to 8-1/2 percent were reaffirmed. While those ranges are only slightly below those set a year ago, the Committee expects that the actual outcome should be much closer to the middle of the range (and near to the anticipated growth in nominal GNP), assuming interest rates prove to be more stable than in recent years.

While anticipating much slower growth than in 1986, the Committee did not set out a specific target range for M1. Given the developments of recent years, uncertainty obviously remains about the long-term relationship between M1 and nominal GNP. That uncertainty about the trend might be encompassed by a relatively wide target range. However, the shorter-term sensitivity of M1 currently to interest rates and other economic and financial variables realistically would require so wide a range (or tolerance for movements outside its bounds) as to provide little

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guidance for the FOMC's operational decisions or reliable information for the Congress or for market participants.

Instead, the Committee will monitor M1 closely in the light of other information, including whether or not changes in that aggregate tend to reinforce or negate concerns arising from movements in M2 and M3. More broadly, the appropriateness of changes in M1 will depend upon evaluation of the growth of the economy and its sustainability and the nature of any emerging price pressures. Among the important factors influencing such judgments may be the performance of the dollar in the exchange markets.

I recognize that the success of that approach rests on good judgment and a degree of prescience. It is justified only by the fact that setting out a precise M1 target -- and weighing it heavily in policy implementation, whatever the circumstances -- would run greater risks for the economy.

I would point out that the sensitivity of M1 to interest rates and other developments will not always work in the direction of relatively high growth. To the contrary, action to reduce the rate of M1 growth, promptly and substantially, would be called for in a context of strongly rising economic activity and signs of emerging and potential price pressures, perhaps related to significant weakness of the dollar externally. In that connection, the Committee explicitly reserves the possibility, in making shorter-run operational decisions from meeting to meeting, to use M1 along with M2 and M3 as a benchmark. Conversely, lower interest rates in a context of weak growth and further progress toward

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reducing inflation pressures would suggest an accommodative approach toward M1 growth.

In fact, the statistical and other signals provided about economic activity and prices seldom are unambiguous or have the same directional implications for policy. In evaluating the evidence as it does appear, the Committee will naturally be sensitive to the desirability of maintaining the forward momentum of the economy, as well as encouraging greater price stability. Quite obviously, our task in that respect will be eased to the extent fiscal policy is consistent with the needed internal and external adjustments.

Most members believe that GNP growth of 2-1/2 to 3 percent is now likely, although a few individual members have higher or lower projections. Such growth should be consistent with continuing sizable gains in employment and a slight downward tilt in the unemployment rate. Members also agree that the rate of price increase is very likely to be greater than last year, essentially because oil prices are expected to average higher and because of the virtual inevitability of higher import prices. The forecasts bunch in the 3 to 3-1/2 percent area for the GNP deflator. That would be about as low as in 1985 despite the special factors working toward higher prices this year.

So far as inflation is concerned, what is critical is that such a bulge in prices related to identifiable temporary external developments not be translated into a broad-based cumulative upward movement. As you well know, just such a cumulative inflationary process started in the 1960s and then

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extended well over a decade into the 1980s. It was eventually brought to an end, but only with great effort and at considerable cost. The scars of that experience remain.

Against that background, participants both in financial markets and in business have persistently been skeptical of prospects for lasting price stability in making investment and pricing decisions. They are bound to be alert and responsive to any sense of adverse change in the underlying inflation trend, with implications for interest rates, exchange rates, and pricing policies. The consequences for the economy would clearly be undesirable.

In effect, neither the internal nor external setting permits thinking of trading off more inflation for more growth. Nor would inflation ease the problem of international adjustment; quite to the contrary, it would both undercut some of our competitive gains and threaten the orderly inflow of funds from abroad. The implications for caution in the conduct of monetary policy are evident.

Concluding Comments

In sum, we face, at one and the same time, most difficult and most promising economic circumstances.

They are difficult because there are obvious distortions and imbalances within our economy and internationally. Unless dealt with forcibly and effectively, those imbalances will impair both growth and price stability -- and the adverse implications will be amplified by the effects on other countries. Moreover, those imbalances will not yield to any single instrument of

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policy, however wisely conducted. Instead, what is required is complementary actions here and abroad -- on budgets, on monetary policies, and on maintaining appropriate exchange rates and an open trading order.

I know none of that is easy. Many countries are involved, and all of them have tough political decisions to make. Nor are the key decisions entirely in the hands of governmental authorities. American industry, in particular, has the challenge to build upon the efforts of recent years toward effective control of costs and greater efficiency, and to seek out and exploit the greater market opportunities that exist today. Banks around the world, despite the frustrations building over time, will need to maintain and reinforce their efforts to deal cooperatively and constructively with the pressing debt problems of their borrowers at home and abroad.

From one point of view, it may seem like a lot to ask. But equally, there is a lot to be gained.

We already have achieved a long economic expansion. We have managed to combine that with progress toward price stability -- and that progress has made possible lower interest rates. Financial markets more generally reflect renewed confidence And the broad outline of policies that can preserve and extend those gains are by now well known.

To fail to act upon those policies -- to instead retreat into protectionism, to relax on inflation, to fail to deal with the deficit -- may in some ways appear to be the course of least

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resistance. But those are also precisely the ways by which we would turn our back to the bright promise before us.

It is only a concerted effort here and abroad that will extend and reinforce the economic expansion, consolidate the progress toward price stability, and provide the international environment in which all countries can prosper.

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