2-23-1988

Statement of Alan Greenspan Before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives

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For release on delivery
10:00 A.M., E.S.T
February 23, 1988

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

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Mr. Chairman, members of the Committee, I appreciate this opportunity to appear before you to discuss the conduct of monetary policy and the economic and financial situation. You have received the more formal report of the Board of Governors detailing the economic and financial situation and reviewing our policy actions in 1987, and presenting our approach to monetary policy this year.

The setting for monetary policy for the year 1988 and beyond is more than normally complex. While the economy itself is well into the sixth year of expansion, the forward momentum of that expansion has been brought into question, and we continue to run sizable external deficits with associated dependencies on foreign savings; at the same time, inflation rates, while below those of earlier in the decade, are still high in a long-term perspective. Moreover, uncertainties persist about key indicators of policy--the monetary aggregates--and their relation to the performance of the economy. Our approach to monetary policy in 1988 will require a delicate balancing of considerations which must take account of the difficult multi-year challenge we face in seeking to wind down our external deficits in a manner that is consistent with the maintenance of sustainable growth in the U.S. and the world economy in 1988 and beyond.

Toward this end, the Federal Open Market Committee two weeks ago set somewhat lower target ranges for 1988, consistent with a moderate pace of monetary expansion this year. The ranges for M2 and M3 are 4 to 8 percent; for debt, we have set a monitoring range of 7 to 11 percent. The annual ranges are wider than in the past, recognizing that the linkage between money and credit growth and economic performance has become noticeably looser in recent years.

Before discussing our monetary policy plans for 1988 in detail, I would like to review with you the developments of the past year.

<u>1987 in Perspective</u>

The year 1987 was a time of economic transition and, like many periods of change, it had its difficult moments. Nevertheless, clear progress was made in achieving a healthier, more balanced economy. For the year as a whole, output and employment expanded strongly. As measured by the gross national product, production increased nearly 4 percent from the fourth quarter of 1986 to the fourth quarter 1987, according to the Commerce Department's preliminary estimates. Almost 3 million persons were added to payrolls over this period. And the civilian unemployment rate dropped to about 5-3/4 percent -- the lowest level in this decade.

We achieved this growth with a better relationship between domestic spending and domestic production. Growth of private domestic final purchases has slowed progressively from 7-3/4 percent in 1983 as the economy emerged from recession to about 1 percent last year. Meanwhile, real exports of goods and services rose more than 15 percent over the four quarters of 1987, as our international competitiveness was enhanced by the success of business and labor in increasing productivity and restraining cost pressures. In addition, the lower level of the dollar on foreign exchange markets, because much of it was not passed through into wage and other costs domestically, also helped our firms price more competitively in foreign markets and compete with imports in the United States. The trade sector improvement accounted for more than a quarter of the overall gain in GNP.

One aspect of the improved trade situation was better balance of our economy internally, with previously lagging sectors showing particular strength. The manufacturing sector revived in 1987; industrial production in manufacturing surged by 5-1/2 percent between December 1986 and December 1987, and capacity utilization rose to its highest level in seven years. For example, output of steel rose especially strongly, which was the main factor in bringing capacity utilization in this industry from about 65 percent at the end of 1986 to above 90 percent at the end of 1987. And other areas of our economy that had been notably depressed earlier in the 1980s, such as farming, mining, and oil extraction, showed some signs of improvement.

The robust growth of the economy -- in combination with the budgetary actions of the Congress and the President, and a one-time boost from tax reform -- brought about a major reduction in the federal budget deficit last year. To be sure, the flow of federal red ink still was heavy, but last December's agreement was at least a first step in needed actions for the future.

On the negative side, inflation increased in 1987. This development was not altogether surprising, given the bounce-back in energy prices early in the year and the effects on import prices of the decline in the dollar. Although wage gains have remained subdued, we clearly need sustained effort to bring about a more stable price level.

As you may recall, the Federal Reserve set ranges for monetary growth in 1987 that were 1/2 percentage point lower than in 1986. We also noted that we would be conducting monetary policy with an eye toward a variety of economic indicators, including the strength of the economy, pressures on prices, and developments in international markets, as well as money growth relative to the ranges.

Although the aggregates from very early in the year tended to run low relative to the ranges, the challenge as we perceived it through much of 1987 was less to buoy money growth than to prevent one-time price rises related to developments in energy and foreign exchange markets from becoming rooted in a renewed inflation process. Concerns about potential inflationary pressures were clearly manifested in financial markets as well. During the spring and again in late summer, inflation worries pushed up commodities prices and long-term interest rates, and heavy downward pressures on the dollar developed in light of growing pessimism about the prospects for significant improvement in U.S. external balances; concerns about the financing of our external deficit in turn apparently added to pressures on interest rates during these episodes. In view of the inflationary potential, the Federal Reserve increased somewhat restraint on reserves in both episodes, and in September raised the discount rate from 5-1/2 to 6 percent.

The balance of risks shifted following the stock market collapse of October 19. The Federal Reserve immediately modified its approach to monetary policy in light of the turbulent financial market conditions. During the crisis, the System temporarily altered its focus somewhat from reserve positions to more direct measures of money market pressures, and took a number of steps to ensure adequate liquidity in the financial system. Moreover, we encouraged some decline in short-term interest rates, as a precautionary step in light of the possibility that the contraction in financial wealth and the deterioration in consumer and business confidence might lead to a significant drop-off in spending.

These actions helped to restore a degree of confidence in financial markets. As this occurred, the Federal Reserve returned some way toward our earlier focus on reserve positions in the day-to-day implementation of policy. But I think it is fair to say that markets still are exhibiting a certain edginess, and we can't be sure yet that normal market functioning has been fully restored following the events of October. In addition, the effects of the stock market events on the economy may not be fully evident. Indeed, indications of some softening in the economy as the year began, against the background of a more stable dollar in foreign exchange markets, led us to take a further small easing step a few weeks ago.

In the context of a monetary policy that, for much of the year, needed to counter inflationary pressures, and in light of the very rapid money growth in 1986 and marked variations in velocity in recent years, modest expansion of the monetary aggregates in 1987 was viewed as acceptable and appropriate. As market interest rates rose, interest rates on deposits became less competitive. This encouraged a shifting away from monetary assets, and growth of all of the monetary aggregates slowed sharply. In addition, some special factors may also have damped money growth last year, such as the effects of the new tax law, changes in bank funding sources, and evolving business practices with respect to cash management and compensating balances. M2 and M3 grew 4 and 5-1/2 percent over the four quarters of last year, respectively, leaving them below and just at the lower ends of their annual ranges. M1 increased 6 percent.

Debt growth slowed to the midpoint of its monitoring range. The progress in reducing the federal budget deficit helped reduce borrowing, and debt issuance by the private sector dropped off as well. Debt growth could scarcely be characterized as slow; at 9-1/2 percent, it continued the pattern of increases relative to GNP.

Economic Outlook and Monetary Policy for 1988

In formulating its monetary policy plans for 1988, the FOMC sought to further a number of complementary objectives. The Committee continued to focus on maintaining the economic expansion and on progress toward price stability, which was seen as a necessary condition for long-term sustained economic growth. It also recognized that satisfactory performance of the economy depended on moving over time toward better balance in our external accounts.

For 1988, Committee members generally were optimistic that policy could be geared to meeting these goals. Most members foresee continued economic growth next year with no significant pickup in inflation, although at current levels of resource utilization and with rising prices of imports likely from recent dollar declines, vigilance against signs of a re-emergence of greater inflationary pressures will continue to be needed. The central tendency of FOMC members' and other Reserve Bank presidents' forecasts is for growth in real GNP of around 2 to 2-1/2 percent from the fourth quarter of 1987 to the fourth quarter of 1988 -- slower than in 1987, but likely close to what is a sustainable pace over the longer haul. The unemployment rate may not drop further, but employment gains could again be substantial and better distributed across industries and geographical regions. Much of the impetus to growth is expected to come from a rapid pace of expansion of net exports of goods and services, which would promote the process of adjustment to better balance internally and externally. This should involve slow growth in domestic demand, probably encompassing damped gains in consumption and a much reduced pace of inventory building from the pace near year-end.

Recent patterns of wage negotiations and settlements do not seem to indicate any imminent break from the restrained behavior of the mid-1980s. Although capacity utilization has risen in our manufacturing sector, bottlenecks are not as yet a problem, and are not expected to become one if growth follows the subdued path of the Committee's outlook for real GNP. Even so, we cannot be complacent about the potential for higher inflation; by the time an acceleration of costs and price pressure were to become evident, the inflation process would already be well entrenched.

With its objectives in mind, as I noted earlier, the FOMC established ranges for M2 and M3 of 4 to 8 percent over the four quarters of 1988, with the debt of domestic nonfinancial sectors expected to increase between 7 and 11 percent. The growth ranges for money represent a decrease from those for 1987 -- by one percentage point in terms of the midpoints. This reduction is viewed as another step in the longer-term process of reducing targeted money growth to rates more in line with reasonable price stability. Moreover, the lower end of the ranges allows for the possibility of little pickup in money growth, especially M2, from 1987 under certain circumstances. If, for example, inflation expectations were to strengthen, market interest rates would tend to rise, and relatively slow money growth could again be an appropriate policy stance.

The FOMC does not anticipate that circumstances will call for such slow money growth. In fact, it expects some acceleration of monetary expansion in 1988, perhaps to around the middle of the ranges. But changing circumstances could easily require a considerably different outcome. In recognition of the unusual degree of uncertainty in the economic outlook and the large movements of money relative to income in recent years, we have widened the specified ranges for monetary growth from the more traditional three percentage points to four points.

This change was advisable partly because the linkage of money to spending and income appears to have become looser in the 1980s. As you know, most historical experience has suggested a fairly close relationship between spending and the quantity of money and, over a longer run, between money and prices. These relationships established the basis for adopting specific targets for growth of money in order to attain the ultimate goals of macroeconomic policy.

But these relationships appear to have changed considerably in the 1980s, partly reflecting the effects of deregulation, innovation, and changing technology.
The spectrum of stores of value is extremely broad, extending from real capital, like plant and equipment and houses on the one hand, through stocks, bonds, and time deposits, to perfectly liquid currency and checking accounts on the other hand. Both households and businesses are continually adjusting their balance sheets and the

allocation of their income flows between accumulation of financial assets of different sorts and acquisition of goods and services.

Transactions balances are on the edge of the exchange of financial claims for goods and services. Regulation and established practices previously acted to enforce a marked separation between transactions money balances and all other balances, and supported a fairly close relationship between spending and the quantity of transactions money -- as measured by M1 -- which allowed it to serve as a monetary policy guide. Businesses and households maintained transactions balances in demand deposits in fairly close relation to their spending requirements, and relied on other forms of deposits to serve as longer-run stores of value.

But now, deregulation and improved information and communications technologies have blurred distinctions between transactions balances and other assets. Businesses can move unneeded transactions balances at each day's close into Eurodollars, repurchase agreements, commercial paper, or CDs, at little cost, with the choice among these instruments often depending on yield differentials of only a few basis points. In addition, firms now can maintain balances in hybrid instruments like MMDAs and money funds and retrieve them nearly as easily as they can from a regular checking account. Remaining business demand deposits serve importantly as balances that compensate banks for services, and these arrangements, too, are evolving over time. For households, NOW accounts -- interest-earning, fully checkable deposits -- are important savings as well as transactions vehicles, and have contributed greatly to the decreasing usefulness of M1 as a monetary target.

This process of innovation and deregulation has affected the behavior of the monetary aggregates in a number of ways, only some of which we fully understand. To some extent, it seems simply to have introduced more "noise" in the money-spending relationship. In addition, though, it appears that one important consequence has been to increase the sensitivity of the demand for monetary assets to changes in market interest rates -- at least over the short run. While deregulation has allowed institutions to vary the rates on deposits, in practice returns on many categories of deposits are adjusted sluggishly in response to changes in market rates, giving rise to relatively large swings in incentives to hold these instruments.

NOW accounts may be the most prominent example of this. Because these accounts are close substitutes for other liquid instruments as a store for savings, holders of NOW accounts are highly sensitive to changes in interest rates on these alternative investments. They place a larger volume of funds into NOW accounts when rates on other deposits at banks and thrifts are relatively low and deposit smaller amounts or actually draw down checking account balances when investment opportunities are more attractive elsewhere.

Widespread compensating balance arrangements for businesses imply a strong interest responsiveness of demand deposits, as well. Changes in market interest rates alter the earnings value of these deposits to banks, with resulting adjustments to the balances required to compensate the bank for a given package of services.

M2 is a broader collection of the public's liquid assets, and as a consequence internalizes some of the shifts that have plagued M1. But M2 is still somewhat limited in its coverage of financial wealth held in liquid forms, and shifts between M2 and other financial assets may not by themselves imply changes in spending tendencies. Such shifts have been responsive to movements in the rates on alternative investments relative to returns on M2 balances. This sensitivity, though considerably less than for M1, also seems to have increased since the late 1970s, perhaps as improved information and communications technologies have facilitated transfer of funds between M2 assets and those outside this aggregate. Over the longer run, once rates on instruments in M2 adjust to changes in market rates, this aggregate tends to grow in line with income, as it has on average over the postwar period.

M3 adds to M2 a number of the managed liabilities that banks and thrifts use to supplement their retail deposits in order to fund credit expansion. Unlike M1 and M2, it is highly responsive to the decisions of institutions as to how fast to expand their balance sheets and what particular sources of funds to rely on. Small changes in interest rate relationships can have very substantial impacts on the funding decisions of these institutions and consequently on M3, without major implications for income and prices.

M3, then, is determined largely by the decisions of depository institutions on how many liabilities and of what type they wish to supply to the markets. The managed liabilities in M3 are very close substitutes for other money market instruments in the public's portfolio. M1 and M2, by contrast, can be thought of as depending more directly on the public's desire to hold the assets included in these aggregates, given the returns on various alternative investments as well as levels of wealth and income. Banks and thrifts, of course, do vary the offering rates on their M2-type deposits in order to affect the quantity of these deposits they receive. But these adjustments tend to lag market rates, and while the M2-holding public is sensitive to alternative yields, it is not nearly as sensitive as the money market investors holding managed liabilities. In these circumstances, the connection between M1 and M2 and the economy rests importantly on the effect of interest rates on the demand for these aggregates. For example, a more expansive monetary policy, increasing reserve availability or lowering the discount rate, boosts demand for these aggregates as interest rates decline, and with a lag stimulates economic activity.

Given uncertainties about how financial market pressures in fact may need to vary in response to changing conditions in the economy, it is difficult in advance to decide on the appropriate growth of an aggregate that is sensitive to movements in interest rates. Such growth could range over a fairly wide spectrum, and still be consistent with satisfactory performance of the economy. In these circumstances, the Committee decided that a modest widening of the ranges for M2 and M3 would better encompass appropriate monetary growth, while still providing a guide to policy.

This analysis also underlies our decision again not to establish a target range for M1. We have monitored the behavior of M1 and conducted careful analyses of its properties. While some of M1's erratic behavior remains unexplained, we now believe that most of its unusual movements relative to income in recent years is attributable to a heightened and now quite large interest elasticity.

In view of this behavior, our calculations suggest that something like a seven-percentage-point range would be needed for M1 in order to encompass the same range of uncertainties as is captured by our four-percentage-point range for M2. Such a wide range would be of little use in the conduct of monetary policy or in communicating the stance of monetary policy to the public.

One should not conclude from this that the Federal Reserve is giving up on monetary targeting. We are not. The linkages between money on the one hand and prices and spending on the other may have loosened, but that is mainly a problem over the short run. The chain still exists. We are continuing to study these relationships carefully; at some point, the shorter-run link could well become tighter again. In any event, economic theory as well as historical evidence are quite persuasive that, over the long run, money, income, and prices tend to move together.

The FOMC expects to achieve its aggregate ranges for 1988 We will, however, need to continue to interpret the incoming information on these measures in light of other data on the performance of the economy and prices, and other indicators of the impact of monetary policy.

The Challenges Ahead

We face formidable challenges over 1988 and beyond in meeting national economic goals of sustaining growth and progress toward price stability. Some of these relate to the short-run outlook for the economy, as the possible effects of the stock market decline and the build-up of inventories late last year work through in 1988.

But our more fundamental task remains managing the process of restoring internal and external balance that is now underway. This is a challenge that cannot be negotiated by the Federal Reserve alone. It will require complementary and consistent actions by our colleagues in the Congress and the administration, as well as by our major trading partners.

For the United States, the most direct and beneficial approach would be to address the problem at its major source--the federal budget deficit. Reducing the deficit further would give us the opportunity to add to domestic saving and reduce dependence on foreign capital, while still encouraging much-needed investment spending. Because the United States is now operating at relatively high rates of resource utilization, domestic demand must be restrained if our international sector is to expand without more inflation. In the absence of fiscal restraint, greater pressures would be felt in financial markets, with negative consequences for investment and other private spending.

While recognizing the need to supply the liquidity required to keep our economy expanding, monetary policy cannot lose sight of the need to keep inflation pressures under control. We cannot permit the price level adjustments associated with restoring external balance to feed through into a renewed inflation process. Escalating prices and costs would reverse the hard-won gains in our international competitive position, leading inevitably to more difficult and wrenching adjustments down the road. Progress toward price stability is the foundation on which the longest peacetime expansion in our nation's history has been built, and continued efforts along this line will be the framework for future economic advances.

Our gains in international competitiveness have reflected a number of factors. But we should not underestimate the effects of the efforts of business and labor over recent years to enhance productivity and restrain costs. And government has made a contribution through deregulation and through the absence of major initiatives that would involve higher business costs.

Our adjustment process by definition has a counterpart for our trading partners. They must promote expansion in their demands and reduce trade barriers to assure active and receptive markets for exports from the United States and elsewhere.

The build-up of imbalances occurred over a period of years, and has involved major adjustments to the structure of economies here and abroad. These will not be reversed easily -- but they must be addressed. We must resist the lure of "short-cuts", such as protectionist measures which would only entrench inefficiencies and reduce living standards at home as well as around the world. We can make this difficult transition, and monetary policy has a key role to play. But if we are to have a chance of doing so without dislocations and detours in our national economic advance, we will have to work together to utilize all the tools at our command.