

# FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1993

---

HEARING  
BEFORE THE  
COMMITTEE ON  
BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE  
ONE HUNDRED THIRD CONGRESS  
FIRST SESSION  
ON  
OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSU-  
ANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF  
1978

---

FEBRUARY 19, 1993

---

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



U.S. GOVERNMENT PRINTING OFFICE

67-884 CC

WASHINGTON : 1993

---

For sale by the U.S. Government Printing Office  
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402  
ISBN 0-16-040864-4

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, Jr., Michigan, *Chairman*

PAUL S. SARBANES, Maryland	ALFONSE M. D'AMATO, New York
CHRISTOPHER J. DODD, Connecticut	PHIL GRAMM, Texas
JIM SASSER, Tennessee	CHRISTOPHER S. BOND, Missouri
RICHARD C. SHELBY, Alabama	CONNIE MACK, Florida
JOHN F. KERRY, Massachusetts	LAUCH FAIRCLOTH, North Carolina
RICHARD H. BRYAN, Nevada	ROBERT F. BENNETT, Utah
BARBARA BOXER, California	WILLIAM V. ROTH, JR., Delaware
BEN NIGHTHORSE CAMPBELL, Colorado	PETE V. DOMENICI, New Mexico
CAROL MOSELEY-BRAUN, Illinois	
PATTY MURRAY, Washington	

STEVEN B. HARRIS, *Staff Director and Chief Counsel*

HOWARD A. MENELL, *Republican Staff Director*

PATRICK J. LAWLER, *Chief Economist*

WAYNE A. ABERNATHY, *Republican Economist*

EDWARD M. MALAN, *Editor*

# CONTENTS

FRIDAY, FEBRUARY 19, 1993

	Page
Opening statement of Chairman Riegle .....	1
Opening statements, comments and prepared statements of:	
Senator D'Amato .....	3
Prepared statement .....	63
Senator Sarbanes .....	4
Senator Kerry .....	6
Senator Roth .....	9
Senator Mack .....	10
Additional comments .....	62
Senator Shelby .....	12
Senator Bennett .....	13
Senator Moseley-Braun .....	13
Senator Murray .....	14
Senator Gramm .....	28
Senator Bryan .....	30
Prepared statement .....	53
Senator Faircloth .....	33

## WITNESS

Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Washington, DC .....	15
Prepared statement .....	54
Supplemental statement .....	62
Response to written questions of Senator Riegle .....	64
Monetary Policy Report to Congress .....	69
Letter to William Albrecht, Acting Chairman, CFTC .....	99

(III)

# FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1993

FRIDAY, FEBRUARY 19, 1993

U.S. SENATE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The committee met at 10:10 a.m., in room SD-G-50 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

## OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The committee will come to order.

Let me welcome all of you here today for this hearing and indicate that we are in an alternative room today because of changes that are going on in some of the other committee rooms in this building.

But let me welcome everyone in attendance and to indicate today is an extremely important hearing for the Banking, Housing, and Urban Affairs Committee, and I think for the Congress.

We have Chairman Greenspan here with us this morning and his testimony, I think, is going to be central to the issue of what happens in the months ahead with respect to our economic performance.

I think also the very substantial turn-out of members of the committee this morning is also evidence of the importance of today's subject.

I will make an opening statement and will call on Senator D'Amato, the Ranking Republican, to also make his statement and then we'll entertain brief statements from other members of the committee, as is our practice. And I would hope that we can keep those statements short in length so that we can go to the Chairman and have plenty of time for questions today.

I know the Chairman has always been accommodating to us in terms of giving us the time we need. And so, I want to be sure today that members on both sides of the aisle have the opportunity to raise all relevant questions with Chairman Greenspan that they have brought with them today.

I think the central question before us this morning is this—if Congress enacts the basic economic growth and deficit reduction plan that was just outlined by President Clinton, will the Federal Reserve support that plan with monetary policies that are necessary to make it work?

It's clear to me that the Fed must provide complementary policies if we are to achieve the goals of the economic plan and, most

especially, the central core element of that plan, which is the creation of 8 million new private sector jobs over the next 4 years.

And I, for one, think it's absolutely essential that that goal be met by our country and that from it, many other important and valuable benefits will accrue to our Nation.

Today, Chairman Greenspan will present to us the Fed's semi-annual monetary policy report with special emphasis on the outlook for the Nation's employment and jobs picture.

Our hearing today is critical in terms of the fact that the country continues to struggle with a serious unemployment problem and with an economic recovery that is uneven, appears to be underway, but is uneven, and we are not seeing a jobs recovery. This is doing, I think, great damage to our country, and certainly, I see that in my home State of Michigan.

Today in America, we have 1½ million fewer jobs than we had just 2½ years ago before the recession started. In fact, we are missing some 4 million jobs that should have been created, using normal historical circumstance as a guide, but those jobs have not been created and the country is limping as a result of that deficiency.

At the same time, a range of significant measures show that inflation is low and does not appear to be a serious problem for the foreseeable future. With considerable idle capacity available and certain deflationary pressures at work, last year's inflation, as measured by the core CPI rate, increased by only 3.3 percent.

Except for the Nixon price control years of 1971 and 1972, that's the lowest inflation rate since 1956. I think experience over these several decades shows that we can live with that.

But we cannot live with the widespread unemployment and underemployment and the backward slide of millions of workers from higher wage to lower wage jobs.

The underclass in America is growing in size and the lack of employment opportunities for those needing work is creating an ever more explosive situation, particularly in our urban centers.

I think a frank assessment of recent Fed policies shows clearly that the Fed has not been able to keep monetary growth targets even within its own self-established range. The record shows that the Federal Reserve has undershot the mid-point of its M2 target range now for 6 straight years. And, in fact, in the most recent year, 1992, the Fed was unable to keep monetary growth even above the bottom of its own target range.

So clearly, something is wrong with that element of Fed policy when there is an inability to keep the targets that the Fed itself has established.

Over the past 3½ years, the Fed has adjusted monetary policy 24 times—twenty-four times—what I think can fairly be called halting steps that failed to give the needed lift and credit strength to the economy.

In fact, on different occasions, Chairman Greenspan, you have acknowledged to this committee and elsewhere where you have been quoted as speaking, that the economy was behaving in a different fashion, and that the Fed was having difficulty understanding and responding to it, and that this may in part explain why the Fed has been unable to meet its own operating goals.

Finally, we have a serious mortgage discrimination problem in America, which Fed studies that we required have now shown. A recent study by the Boston Fed established that after all legitimate credit situations were taken into account, black applicants for mortgages were 60 percent more likely to be turned down than white applicants with the same circumstances.

Now, this is both illegal and is just plain wrong. This practice is damaging millions of citizens across this country. It's hurting the communities involved, and it's hurting our country, and it has to be stopped. And I mean stopped.

Now the Federal Reserve, I think, has an affirmative obligation to act forcefully to end these patterns of racial discrimination in bank lending and also the practices of reverse redlining which have also come to light.

And so, I would hope that the Fed not only would have a very aggressive plan of action to get that done in light of its own studies of the problem in this area, but I think hearings, regional hearings across the country to get this issue out into the light of day and to stop these improper practices is something that the Fed should be undertaking. I would like to have a response from you on this matter as well this morning.

Senator D'Amato?

#### OPENING STATEMENT OF ALFONSE M. D'AMATO

Senator D'AMATO. Well, thank you very much, Mr. Chairman.

It's always good to see Chairman Greenspan here. It generally provides for lively dialog. I don't know if much more, but at least that.

Mr. Chairman, I'm going to ask that the full text of my statement, which has been magnificently prepared by a brilliant staff, be entered into the record as if read in its entirety.

The CHAIRMAN. Without objection, it is so ordered.

Senator D'AMATO. And then I will attempt in my own way to pose kind of a question and a statement to Chairman Greenspan because if I can understand what they say, most people should be able to pick it up.

Chairman Greenspan, in your written testimony, on page 13, you indicate that there is no credit crunch for homebuyers because there's a strong secondary market in mortgage-backed securities. It does say that. I don't know whether you also have a brilliant staff, so that's what they put in there, Alan.

[Laughter.]

And your statement acknowledges—I wish you had done it before, but better late than never. You acknowledge that there is a problem with respect to getting credit to small businesses. And there are a whole host of reasons—regulatory rules, reserve requirements, et cetera. And I'm not going to argue with any of those because it seems to me we have a unique opportunity to do something that really makes sense. I would hope that the majority of the members of this committee can work together and work out whatever glitches may be contained in legislation that we have co-sponsored, the "Small Business Loan Securitization and Secondary Market Enhancement Act."

This is similar to what we did in 1984 when we lifted the restrictions that kept banks from securitizing their mortgages, the home mortgages, and then selling them and creating this great pool of money that could then be used so that the banks could get those loans off their books and make more loans available to home-buyers.

It's worked.

My question is this—wouldn't that free up trillions, potentially trillions of dollars, certainly billions of dollars, that could be put out there in the private sector to the small business area that creates jobs?

And President Clinton said it. He said, look, we need credit for small businesses. Isn't this the way to make it possible to facilitate the banks making more credit available to the small businesses?

I think the American people sometimes see it taking place, but they don't recognize that, nation-wide, it is small businesses that create the jobs.

Between 1980 and 1987, while the Fortune 500 were cutting back by 3.1 million jobs, those small businesses were creating 17 million new jobs.

And so, that's the problem. And all the Government programs and all the Government spending in the world is not going to get credit to the small businessman. We don't have enough money in the Federal Government to give that kind of credit, nor should we be doing it. And if we tried the people would be saying, what are you doing?

So, my question to you, and if you'd like to think about it, and in your remarks, maybe comment on it—what about opening up that secondary market to the small business community by removing some of those impediments that presently exist, as they did at one time in 1984 for home mortgages?

I think that we can do it. We can make an incredible contribution to the economy and to moving it forward and to creating jobs in the old-fashioned way—let the system work. Let hard work and entrepreneurship do the job. That's what I'm going to be asking you to direct yourself toward.

Thank you.

The CHAIRMAN. Thank you, Senator D'Amato.  
Senator Sarbanes?

#### OPENING STATEMENT OF PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. It's always a pleasure to welcome Chairman Greenspan to the Banking Committee and we appreciate his appearance here this morning to testify on the Federal Reserve's monetary policy report, pursuant to the requirements in the Humphrey-Hawkins legislation.

This is a particularly appropriate moment for the Federal Reserve to come before the Congress to report on its conduct of monetary policy.

On Wednesday evening, President Clinton came before the Congress to lay out the details of his fiscal program. That program provides for some short-term economic stimulus to move the economy on to a higher growth path in order to create jobs and put people

back to work, coupled with, in my judgment, a very credible, long-term deficit reduction plan.

The President has really, I think, faced the issues. I think he's analyzed them correctly and I think he has recommended measures to deal with them that, if we can enact them in roughly the way they've been presented, I assume, as it moves through the legislative process, obviously, there will be changed here and there and, in fact, there are some details that I would change, but the overall thrust of the program I think is the kind of medicine that we need.

It is clear, however, that even if the President and the Congress are successful in working together to enact this fiscal program, that the overall success or failure of that program in dealing with the economy will be very dependent on the conduct of monetary policy by the Federal Reserve Board. And therefore, Chairman Greenspan, I think you and your colleagues at this particular juncture in our Nation's economic history are carrying an especially heavy responsibility.

There's good reason to believe that modern economic history has not had a recession recovery period with so little stimulus from monetary and fiscal policy taken together, combined, as the current recession recovery period.

Now we've had some people work over data compiled by the staff of the Federal Reserve Board, by your own staff, on fiscal impulse data compiled by the Federal Reserve staff.

According to that data, in three of the four recessions prior to the most recent one, 1960 to 1962, 1973 to 1976, and 1981 to 1984, the Federal Government pursued expansionary fiscal policies in excess of three-quarters of a percent of GDP. Only in the recession of 1969 to 1972, was there a modest contraction of fiscal policy. In this recession, the recession of 1990 to 1992, however, fiscal policy had a contractionary effect in excess of half a percent of GDP.

We've put this into a chart just to make it very clear. These are the different recession periods. This is the thrust of discretionary fiscal policy, both from the cycle peak to 7 quarters after the trough. And as you can see, it was expansionary in those three recession recovery periods, contractionary in this one (indicating), and even more contractionary—this is fiscal policy, now, government spending and taxing—and even more contractionary in this recession, 1990 to 1992.

Yet, despite the fact that fiscal policy in the most recent recession was more contractionary than any of the past five recessions, monetary policy, as measured by the real prime rate, was the same or more restrictive than monetary policy in each of the other recessions, except for 1981 to 1984.

In that recession, while monetary policy was more restrictive than it has been in this recession, the Federal Government pursued by far the most expansionary fiscal policy of any of the five recessionary periods, an expansionary thrust in excess of 1½ percent of GDP.

The point is that in the recession of 1990 to 1992, contractionary fiscal policy was combined with a relatively restrictive monetary policy.

Now I think the monetary policy in this period has been, in comparison, I think, just in comparison to monetary policy, has been

quite restrictive, although not as restrictive in 1981–1984, on this standard.

But if you take the monetary policy and put it together with the fiscal policy, and look at the overall impact of that, this is the most contractionary overall economic policy we've had in addressing any of these recession recovery periods in our recent history.

Even with a somewhat improved economic performance of the past few months, it is not clear that our economy can achieve a rate of growth sufficient to reduce substantially our current level of unemployment. In fact, the unemployment rate today, 22 months after the trough, is higher than the unemployment rate was at the trough of the recession.

We've never had that before. There's no previous recession this post-war period where 22 months after the trough, the unemployment rate was still higher than it had been at the trough of the recession.

Indeed, I think that is why President Clinton included a short-term stimulus program in his message to Congress. Now, further, it seems to me clear that if a substantial deficit reduction program comes into place to be implemented in very short order in the coming fiscal year, the need for monetary policy accommodation will be paramount.

In other words, we've got the economy—it's a little bit like a plane starting to take off. It's starting to move up. The President wants to give it some stimulus in order to give it an extra thrust. So as the deficit reduction fastens onto it, which of course could have an effect but there is enough movement and thrust in the economy to keep going. We don't get pushed down into a third dip.

Now I think we badly need monetary policy accommodation to be certain that that forward, upward movement of the economy can be sustained, and that it can withstand the deficit reduction program without being tipped downwards.

Therefore, Chairman Riegle, let me say in conclusion, in my view, we are at a critical juncture for the economic future of our country. The participation of the Federal Reserve in this effort to restore the Nation's economic health is essential, absolutely essential.

I look forward to Chairman Greenspan's testimony this morning on this very critical question.

The CHAIRMAN. Thank you, Senator Sarbanes.

Senator Faircloth?

Senator FAIRCLOTH. Mr. Chairman, I do not have a statement. I'll wait for the questioning.

The CHAIRMAN. Thank you. Senator Kerry?

#### OPENING STATEMENT OF SENATOR JOHN F. KERRY

Senator KERRY. Thank you very much, Mr. Chairman. I would like to take a moment to simply underscore the central points that both the Chairman and Senator Sarbanes have just made.

While I know I'm slightly repetitive, I think it bears repetition. I think it is important for you to understand the views of all of us here. It is significant that so many Senators are here this morning on a Friday when votes are not going to take place. It is a mark, I think, of the importance of this particular hearing.

I would first of all begin by thanking you for your presence at the State of the Union message. I think your being there, standing shoulder-to-shoulder with Hillary Clinton was an important message to the country and we hope that that is a signal that you will indeed be sensitive, as Senator Sarbanes and Senator Riegle have mentioned.

You've heard me personally and you've heard other members of this committee lament the phony budgets, the phony figures, the false expectations on interest, on growth, on deficit reduction. Some of us voted against the last budgets for that reason.

Now we have for the first time in 12 years a President who has spoken the truth to the American people. Some people may disagree with portions of the cuts or the revenue or whatever. But I think it's really hard to disagree that there's courage in the President's proposals.

I am particularly concerned because, for at least 2 years, members of this committee have been screaming about the credit crunch problems. And you've responded to us, saying you would look at it. You had some concerns about it.

Today, in your testimony, I think for the first time, page 12 of your testimony, you say very clearly that there is a crunch. You say the supplies of credit by depositories have been constrained and you point to market problems and regulatory pressure as causing that.

I think that's a very significant acknowledgement. In addition, on the next page, you talk about how historically banking institutions have played a critical role in financing small- and medium-sized businesses, the key for the growth in the economy, and that now, many of those are not doing that.

This may be chart day in this committee. I suppose we ought to say that, long before Ross Perot came around, we were using charts.

[Laughter.]

Senator SARBANES. That's right. We want that on the record.

Senator KERRY. We want that on the record.

[Laughter.]

But I'd just like to point this out, that of all the people employed in the United States, this chart represents, mid-sized, small and large.

Obviously, if there's going to be a recovery in America, it has to come from the 71-percent employment base that is small business. We understand that, and Senator D'Amato was acknowledging that.

Now if you look in the last years at what's happening to commercial loans to those businesses, this is a reflection of commercial and industrial loans, in the billions over the last quarters. And it is clear that the line is now on a decrease from 3 years ago, while Treasury holdings of the banks are on a very significant upscale. As of now, Treasury holdings actually exceed commercial and industrial loans, documenting what many of us have been saying—that there is an incentive in the system for banks not to lend, but to simply purchase Treasury notes, and take the spread and make a profit or survive that way.

Senator SARBANES. Will the Senator yield for a question on that?

Senator KERRY. Absolutely.

Senator SARBANES. Is the bottom line the timeline on that chart?

Senator KERRY. These are the quarters, yes.

Senator SARBANES. And so when did it really begin to sort of shoot up there?

Senator KERRY. It really began to shoot up in 3/89, the third quarter of 1989.

Senator SARBANES. And then just continue.

Senator KERRY. In 1989, it began to take a very significant increase, right up until 1992.

And finally, the Chairman spoke of the job recovery problem. I think this is where your role is going to be so critical, as Senator Sarbanes has said.

This is a reflection of the past three recoveries of the 1980's. This is the beginning point of the average of the past three recoveries and job creation. We had, for every 100 jobs in America, there was about 4 percent increase in job during the last three recoveries.

In the current recovery, however, as you can see, it's almost stable, absolutely stable. Point 02 or 3 percent in job increase in America.

You pick up today's newspaper and you see that 28,000 jobs are being lost at Boeing. Nevertheless, you look at The Washington Post story, it talks about, three different reports talking about strong recovery.

It's very clear, as the Chairman has said, that, unless you're creating jobs, unless that small business sector is getting credit, we could lose whatever recovery there is very quickly.

Now, your targets on monetary policy have indicated already a reduction in the growth. Originally, it was 2½ percent to 6½ percent. I believe you've now reduced that already by one-half percent.

So, let me just quote what Laura Tyson, the chairman of the Council of Economic Advisers, said before she took her current position. She wrote that the Federal Reserve is still fighting the last war on inflation and has waited too long to ease the credit crunch strangling domestic spending.

Now, we've been through this debate a little bit here previously. But I just want to underscore my sense of the critical nature of your relationship to whatever sacrifices the American people are called on to make and to whatever choices we make in Congress.

We could do this. We could pass this legislation. We could have an important measure of reality enter the democratic process of this country, only to have it stifled by an effort to fight inflation that isn't there.

If you look at the Consumer Price Index, I recognize that there was a 0.5 increase on the last month, which is the largest we've had in 2 years. But it went up by 3 percent last year. Nonfarm unit labor costs increased by only 1 percent.

In my part of the country, I can tell you that many creditworthy small businesses just still are not getting loans and are going under. And so, my plea to you, Mr. Chairman, is that you and the governors join in this effort and help us to not be hung out there on a limb where we may do what we consider to be the right things and the monetary policy, as Senator Sarbanes says, just takes the

lift out from under the wings. I think this is a very important thing for us to talk about.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Roth?

**OPENING STATEMENT OF SENATOR WILLIAM V. ROTH, JR.**

Senator ROTH. Thank you, Mr. Chairman. It's always a pleasure to welcome Chairman Greenspan before us.

Over the next few months, our focus will be on the President's tax and spend plan. One concern I have is that the \$250 billion in new taxes requested by the President will choke off the economic improvement now underway. Yet, economic growth and job creation should be the two main priorities of economic policy.

As I've said many times before, we cannot tax ourself into prosperity. No economic school of thought I'm aware of recommends raising taxes at a time of economic vulnerability. And certainly, the experience under the 1990 Budget Act should make Congress very wary about risking the health of the economy yet again.

The economy has only recently recovered from this debacle and this tax increase is only one of the Government-imposed burdens undermining economic and job growth.

I won't read my entire statement, Mr. Chairman. I'll ask that it be included as if read. But I would just like to point out that it does seem to me that it's ironic that with this new package of more than two dozen major tax increases, that it flies in the face of what we've learned from the history.

Let me just quote from the first paragraph of the prestigious British news magazine, *The Economist*. In an article entitled, "No Need For a Boost," this responsible magazine maintains that when George Bush lost his presidency 3 years ago, the American economy was growing at a pace that would mightily have impressed most voters had they known about it.

The article goes on to explain that our gross domestic product expanded at an annual rate of 3.4 percent in the July-September quarter, 3.8 percent in October-December. Our business investment is strong, expending at an annual rate of 8 percent. Consumer spending is growing. Inflation is low, and the future appears bright.

But one of the things that I'm going to be very much interested in, Mr. Chairman, is whether the kind of program proposed by the President, on the one hand, a jump-start, and the other, a tax increase, makes sense, or would we be better of leaving it alone.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Roth. Because we got a late start, I'm going to ask all other members—we'll put the statements in the record. I'd like to keep the opening statements to a minute or two, if I can. I know that's not easy because this is—

Senator D'AMATO. I think, Mr. Chairman, I know Senator Mack has a statement he has worked on. I'd ask that we provide him that opportunity.

The CHAIRMAN. By all means. I'm going to call on each member.

Senator MACK. I don't want to be argumentative, but I don't really plan now to keep my comments to one or two minutes. We've

heard a number of comments on your side of the aisle that I want to have an opportunity to respond to.

The CHAIRMAN. Senator Bryan?

Senator BRYAN. Mr. Chairman, I'm going to forgo an opening statement, and ask that my full text be made a part of the record.

The CHAIRMAN. Without objection.

Senator BRYAN. And I'll get into my portion during the question and answer segment.

The CHAIRMAN. Very good. Thank you, Senator Bryan.  
Senator Mack?

#### OPENING STATEMENT OF SENATOR CONNIE MACK

Senator MACK. Welcome, Chairman Greenspan.

I did not come here with a prepared statement. In fact, I'm looking forward to hearing from you. But there are a couple of things that have been said this morning that I think it's important to respond to.

My initial intention was to focus on the issue of the credit crunch, as well as the so-called economic stimulus plan. But let me just for the moment confine my thoughts to the credit crunch.

I think that if almost any business person in this country were sitting in the chair of the president of any bank in the Nation, whether that be small or large, they probably would have come to the same conclusion that most bankers in this country have come to at this time.

My point is, as an individual that is running an institution, their responsibility is to provide profits to their stockholders. As they go through the process of trying to decide where they're going to invest the money received from their depositors, they generally choose between treasuries, on one hand, loans on the other.

When that individual or those committees work through where they're going to make those investments, they try to calculate what the bottom-line profit is from those investments would be. They think of things such as—well, I'm sure that a board member tries to analyze what the potential liability to that board member is for making the decision to extend credit to various kinds of companies in analyzing that risk.

The bank tries to determine what the costs are that are related to that particular loan, cost not only in the sense of what is the cost of money, but what is the potential risk, what is the risk that I am going to be subjected to for a potential failure to carry out a particular piece of social objective or social legislation, whether that's the Community Reinvestment Act or the Home Mortgage Disclosure Act or Truth-in-Lending. When they get to the bottom of that, they calculate that cost.

On the other hand, they look at what they can make with respect to in the treasuries market or in some other form of investment. As I said, I think most people today, I don't care whether they are a banker or not, sitting in that chair, will come to the conclusion that the highest profit that can be made, with less risk, less cost, less capital requirement is in investing in U.S. Treasury Bonds.

Now what we have heard here, and it's happened in the ten years that I've been around, is that Congress always wants to find somebody else to blame for the problem. It's interesting that the

Chairman, in his opening remarks, talking about now holding another set of hearings around the country about discrimination in lending.

Everyone hates discrimination in lending. However, what this effort probably is going to produce is another series of ideas, proposals, legislation to further burden the cost of financial institutions and increase their cost of doing business and this will provide more incentive to put money into government bonds, not into the community.

How well-intended it might be, I want you to understand that you in fact are moving in a direction that may do just the opposite of what you're trying to accomplish.

It also is interesting that this committee is talking about their desire to see that money goes into the small businesses in our country. And yes, the Senator from the New England States certainly raised the concern about the lack of credit, and has done so for a long period of time.

But I would remind the committee that it was the Chairman and the Democrats primarily on this committee that beat up the former comptroller, Bob Clark, for not being tough enough. We said at that time, what you're doing is sending a message to the regulators—get out there and be a little tougher.

All I'm saying to my colleagues is that I think we need to understand that there's a role we play. We can't just point to Chairman Greenspan and say, it's up to him to see that the future or that the economic plan that's being offered by the President is going to work.

There are things in my opinion that this committee has done that has in fact encouraged money to go into investments as opposed to lending in the community. I think it's important that we understand that.

With respect to the economic stimulus, I will wait and ask my questions about your ideas with respect to that proposal. I thought it was important, at least for me, to get on the record what I think the role that this committee plays.

Senator KERRY. Mr. Chairman, could I just take 30 seconds?

The CHAIRMAN. If I may, first, let me just respond to one thing that Senator Mack said, and I appreciate the points that he made because I think we have a very good working relationship, generally speaking, on this committee.

In terms of mortgage discrimination and lending, it's against the law. It's against the law that exists today. And it's happening in a very substantial way, according to studies that the Fed has just produced.

I think that illegal activity has to stop. And I would not want any inference left on the record, and I don't say you intend to put one there, that if we stop an illegal practice, that we're somehow hurting the credit system or imposing ourselves on the banks.

I think the illegal practices have to be stopped and I would hope that everybody here would join me in being direct and forceful and aggressive about it. We're talking about obeying the law and not violating the law in terms of mortgage discrimination.

Senator MACK. I think I was clear again with what I had to say, that there is a consequence for the actions that this committee

takes. It does in fact have an impact on the flow of credit in this Nation. And that was my point.

The CHAIRMAN. Senator Kerry, just very briefly.

Senator KERRY. Just 30 seconds, if I may. If I might just point out to my friend, and I appreciate his comments, indeed, there is a bottom line and lending requires people to make judgments.

The Fed Reserve has done a study in New England, and the Fed Reserve study has found that cease and desist orders have caused a lot of the banks to call in good loans and to really squeeze down the portfolios in a way that have taken the people who can pay it back, not the people who can't pay it back because they're being forced to reduce their ratios.

So they've had this pressure to reduce ratios, they've turned to good, ongoing businesses to do it. And this is not a congressional finger-pointing. This is a Fed Reserve finger-pointing.

And the second thing I say to you is Bob Clark was not reconfirmed, and I joined a number of other people here in voting against him after repeatedly pointing out that they were choking and being excessive and not dealing with the regulators properly.

So while there was an initial hue and cry from the Congress that called attention to the fact that the regulators hadn't done their job, it was then an excess and that excess has cost many legitimate businesses their livelihood. They are in bankruptcy today.

The CHAIRMAN. Senator Shelby?

#### OPENING STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Mr. Chairman, I would ask that my entire statement be made a part of the record.

The CHAIRMAN. Without objection.

Senator SHELBY. And I have a couple of comments.

Chairman Greenspan, I'm very interested, as all America is, I suppose, in your reaction to the administration's proposal. As I read the administration's plan, it seems that 70 percent of deficit reduction will be financed by tax increases rather than spending cuts.

Do we need a short-term stimulus that creates short-term jobs, for the most part? Have we cut spending enough? How severe is the impact of these higher taxes on the economy? You're in a position to gauge this better than most.

I'm also, Chairman Greenspan, interested in economic assumptions used by the President. For example, the President relies on the economic assumptions compiled by the Congressional Budget Office. He predicts short-term T-bill rates at 4.3 percent for 1994, and 10-year Treasury note rates of 6.6 percent.

Given the lack of emphasis that I see on spending cuts in the proposal, do you believe that the investors will retain the level of confidence suggested by these rates?

I think that's very important, too, and I know you're going to have a chance to comment on all this. I've got to go to another hearing and I won't be able to stay.

Thank you, Mr. Chairman.

The CHAIRMAN. Very good. Senator Bennett?

**OPENING STATEMENT OF SENATOR ROBERT F. BENNETT**

Senator BENNETT. Thank you, Mr. Chairman.

I haven't been around here long enough to discover where the chart room is, so I don't have any of those to show you.

[Laughter.]

But from this morning's newspaper, I'd like to put together the thrust of the things that I would be interested in having you address. I very carefully avoided The Wall Street Journal. This will all be from The New York Times.

The White House's own figures, ambiguous on Wednesday night, showed clearly today that all of the deficit reduction in the next 2 years will come out of new taxes rather than a combination of taxes and spending cuts. The cuts will contribute only in 1995 and 1996.

And then across the page, it says, the budget documents published today show that while the deficit would be cut by \$39 billion next year and \$54 billion in 1995, Government spending, now more than \$1 trillion a year, would be reduced by only \$5 billion next year and \$6 billion in 1995.

All the rest of the deficit reduction would be accomplished by tax increases. Only in the last 2 years of Mr. Clinton's term would spending cuts begin to bite.

Then in the commentary, and this is the point that I hope you will address, along with Senator Shelby, these are the points he's raised—President Clinton's economic plan might not produce the burst of growth in new jobs that he hoped for because of important unintended consequences, such as fears that higher taxes could hurt consumer confidence and slow growth.

While the President no doubt hoped his package of stimulus and deficit reduction measures would cheer up consumers and business, the higher taxes he proposed could do just the opposite—dragging down consumer confidence and frightening corporations and investors.

The stock market's jittery behavior this week, as an example, these factors could be a recipe for slower growth.

Now, as you know, from my previous questioning of you in the Joint Economic Committee, Mr. Greenspan, I'm very concerned about growth, and growth in the small business sector, growth in the entrepreneurial side of the economy.

I'm a little concerned that the President's reliance on taxes in the first 2 years, with the spending cuts to take place only in the out-years, where by history, we've discovered things don't usually work out the way they are projected to work out in the closer years, could be a concern for us. And I'd hope you would address that. Thank you, Mr. Chairman.

The Chairman. Thank you, Senator Bennett.

Senator Moseley-Braun?

**OPENING STATEMENT OF SENATOR CAROL MOSELEY-BRAUN**

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman.

I'm also new around here and I'm little worried. It's almost 11:00 and we haven't heard from Mr. Greenspan yet. So I really want to be very brief. So I'd like, Mr. Chairman, for my remarks to go into the record.

The CHAIRMAN. Without objection, it's so ordered.

Senator MOSELEY-BRAUN. But I'd like to first thank Mr. Greenspan. We had a delightful conversation the other day about the kinds of issues that the Fed has to negotiate.

I would like to pursue two questions, one that I think has been asked by the committee members already, and another that concerns me that I think might have an impact.

The first, of course—I have a sense that a number of the members have been asking how active a role you see the Fed as playing with regard to push the economy in the direction of President Clinton's plan.

I don't know. I don't read congressional tea leaves yet, but your appearance at the State of the Union address seemed to signal that you were prepared to help with this program.

I don't know if that assumption, or to what extent that assumption is legitimate, and I'd like to hear you talk about the role that you see yourself at the Fed playing in regards to Clinton's proposal to stimulate this economy.

The second question that I would like, part of our conversation the other day had to do with the internationalization of economic activity and decision-making and how it is that you have to take into account a lot more than just domestic issues and fiscal policy, domestic fiscal policy in terms of decision-making, particularly in a time when we are all looking at growth in the economy, we're all looking at world-wide issues affecting what happens here in America.

My question to you, how do you see your role in terms of bringing together all these disparate impacts on our monetary and fiscal policy with regard to the role that the Fed will play?

And with that, I guess and, finally, we talked about your statement that really struck me the other day, was that history could provide us with some clues, but no roadmap for this situation.

That's my characterization of what you said. And the Chairman, Chairman Greenspan, Mr. Chairman, referenced the 1870 recession as the last time we had seen anything like this.

But, clearly, circumstances have changed greatly since the 1870's, or even 1907. I would be very interested in what goes into your thinking about how we can best reconcile the competing forces of inflation, on the one hand, which nobody wants to see, or a molasses economy, which is what we have right now.

Thank you.

The CHAIRMAN. Senator Murray?

#### OPENING STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Thank you, Mr. Chairman. I apologize for being late. I have a budget hearing that's going on at the same time as this. But I do want to get to the words from Dr. Greenspan and will pass on an opening statement.

Let me just simply say that, for the working people, we hope that we can keep interest rates low, and I hope that you address those comments in your remarks and I look forward to hearing them.

The CHAIRMAN. Chairman Greenspan, we're going to make your full statement a part of the record. We'd be very pleased to hear from you now.

**STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC**

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

My statement is longer than is usual, as is the case with the Humphrey-Hawkins testimony. But I've tried to slim it down as much as I can.

The CHAIRMAN. Maybe I can ask you, if you would, to pull the microphone just a little closer so that people can hear you in the back of the room. Thank you.

Mr. GREENSPAN. Mr. Chairman, I appreciate this opportunity to discuss with you and the other members of the committee developments in the economy and the conduct of monetary policy. 1992 saw an improved performance of our economy. The expansion firmed, and inflation moderated. Some of the structural impediments to growth seemed to diminish. In particular, the financial condition of households, firms, and financial institutions improved. In addition, confidence rebounded late in the year.

Nevertheless, the expansion seemed to exhibit little momentum through most of 1992. Unemployment remained high and money and credit growth were sluggish. In response, the Federal Reserve took steps to increase the availability of bank reserves on several occasions. These actions brought short-term interest rates to their lowest levels in 30 years.

Long-term interest rates also fell in 1992 and early 1993 as inflation expectations gradually moderated and optimism developed about a potential for genuine progress in reducing Federal budget deficits.

Mr. Chairman, in the last few years, our economy has been held back by a variety of structural factors that have not been typical of post-World War II business cycles, certainly not occurring all at once. These factors have included record debt burdens, overbuilding in commercial real estate, and a substantial cutback in defense spending. Our monetary policy actions have been directed at facilitating adjustments to these developments and have in the process improved our economy's prospects for long-run sustainable growth. Significant hurdles, of course, still remain to be overcome in the short run. Nonetheless, in the view of the vast majority of business analysts, prospects appear reasonable for continued economic expansion and further declines in the unemployment rate. The tasks of monetary and fiscal authorities alike will be not only to support this prospective growth, but also to set policies to enhance the capacity of our economy to produce rising living standards over time. Before discussing the outlook in more detail, I would like to reflect on how monetary policy has interacted with the forces that have shaped developments over recent years.

I have often noted before this committee the distinctly different nature of the current business cycle. A number of extraordinary factors contributed to the earlier weakening in the economy and have worked against a brisk and normal rebound from recession.

Balance sheet restructuring has been perhaps the most important of these factors. In the 1980's, debt growth, hand in hand with rising asset prices, considerably exceeded that of income, and debt burdens rose to record levels. Debt-financed construction in the

commercial real estate market was an extreme manifestation of this development, but it was apparent as well in other sectors of the economy.

The difficulties faced by borrowers in servicing their debts as the expansion slowed and the levelling out or decline in asset prices prompted many to cut back expenditures and divert abnormal proportions of their cashflows to debt repayment. This in turn fed back into slower economic growth. In addition, financial institutions were faced with impaired equity positions owing to sizable loan losses as well as more stringent supervision and regulation and demands by investors and regulators for better capital ratios. In response, they limited the availability of credit with particular effects on smaller businesses.

Intensive business restructuring has been another important characteristic of the evolving economic situation. In an environment of weak demand and intense competition here and abroad, many firms have found it necessary to take aggressive measures to reduce costs. These actions have included selling or closing down unprofitable units and reducing their work force. The process of restructuring has been given added momentum by the availability of new computing and communication technologies.

The contraction in defense spending has been a third development restraining the expansion. Real Federal defense expenditures dropped about 6 percent in 1992, and are down 9 percent from their 1987 peak. Those regions of the country with substantial defense-related activity have been among the areas whose economies have performed especially poorly.

Another, less-discussed factor that contributed to the formulation of our recent monetary policy dates not from the 1980's, but, rather, from the 1970's—inflation and inflation expectations. Over the past decade or so, the importance of the interactions of monetary policy with these expectations has become increasingly apparent.

Through the first two decades of the post World War II period, this interaction was patently less important. Savers and investors, firms and households made economic and financial decisions based on an implicit assumption that inflation, over the long run, would remain low enough to be inconsequential. There was a sense that our institutional structure and culture, unlike those of many other nations of the world, were alien to inflation. As a consequence, inflation premiums embodied in long-term interest rates were low and effectively capped. Inflation expectations were reasonably impervious to unexpected shifts in aggregate demand or supply. In those circumstances, monetary policy had far more room to maneuver; monetary policy, for example, could ease aggressively without igniting inflation expectations.

Even during the rise in inflation of the late 1960's and 1970's, there was a clear reluctance to believe that the inflation being experienced was other than transitory. It was presumed that inflation would eventually retreat to the 1 to 2 percent area that prevailed during the 1950's and the first half of the 1960's. Consequently, long-term interest rates remained contained.

But the dam eventually broke, and the huge losses suffered by bondholders during the 1970's and early 1980's sensitized them to the slightest sign, real or imagined, of rising inflation. At the first

indication of an inflationary policy, monetary or fiscal, investors dumped bonds, driving up long-term interest rates.

This heightened sensitivity affects the way monetary policy interacts with the economy. An overly expansionary monetary policy, or even its anticipation, is embedded fairly soon in higher inflation expectations and nominal bond yields. To be sure, a stimulative monetary policy can prompt a short-run acceleration of economic activity. But the experience of the 1970's provided convincing evidence that there is no lasting tradeoff between inflation and unemployment. In the long run, higher inflation buys no increase in employment.

This view of the capabilities of monetary policy is entirely consistent with the Humphrey-Hawkins Act. As you know, the Act requires the Federal Reserve to "maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The goal of moderate long-term interest rates is particularly relevant in the current circumstances, in which balance sheet constraints have been a major, if not the major, drag on expansion. The halting, but substantial, declines in intermediate and long-term interest rates that have occurred over the past few years have been the single most important factor encouraging balance sheet restructuring by households and firms and fostering the very significant reductions in debt service burdens. And monetary policy has played a crucial role in facilitating balance sheet adjustments—and thus enhancing the sustainability of the expansion—by easing in measured steps, gradually convincing investors that inflation was likely to remain subdued and fostering the decline in long-term interest rates.

Although the easing actions over the past few years have been purposely gradual, cumulatively they have been quite large. Short-term interest rates have been reduced since their 1989 peak by nearly 7 percentage points. Some have argued that monetary policy has been too cautious, that rates should have been lowered more sharply or in larger increments.

In my view, these arguments miss the crucial features of our current experience: the sensitivity of inflation expectations and the necessity to work through structural imbalances in order to establish a basis for sustained growth. In these circumstances, monetary policy clearly has a role to play in helping the economy to grow; the process by which monetary policy can contribute, however, has been different in some respects than in past business cycles. Lower intermediate- and long-term interest rates and inflation are essential to the structural adjustments in our economy, and monetary policy thus has given considerable weight to helping such rates move lower.

Some have suggested that the decline in inflation permitted more aggressive moves and, had the downward trajectory of short-term interest rates been a bit steeper, that aggregate demand would have been appreciably stronger. I question that as well. Basing this argument on the lower inflation that has occurred is a non sequitur; the disinflation very likely would not have occurred in the con-

text of an appreciably more stimulative policy, and such a policy could have led to higher inflation in the next few years. Moreover, such a policy would not have dealt fundamentally with the very real imbalances in our economy that needed to be resolved before sustainable growth could resume. The credibility of noninflationary policies would have been strained and longer-term interest rates likely would be higher, inhibiting the restructuring of balance sheets and reducing the odds of sustainable growth.

Recent evidence suggests that our approach to monetary policy in recent years has been appropriate and productive. Even by last July, when I presented our midyear report to the Congress, some straws in the wind suggested that the easing of monetary policy to that date and the various financial adjustments underway in the economy were proving successful in paving the way for better economic performance.

It is now apparent that our July expectation of a firmer trajectory of output has been borne out. Gross domestic product growth is estimated to have picked up to a 3½ percent rate during the second half of 1992, following a more modest increase in the first half. And indications are that the expansion is continuing in the early months of 1993.

The news on inflation in 1992 likewise was quite encouraging. The Consumer Price Index rose just 3 percent in 1992. Excluding volatile food and energy prices, inflation last year was the lowest in two decades.

These favorable outcomes occurred despite slow growth of the money and credit aggregates. Both of the monetary aggregates finished the year about ½ percentage point below their ranges, and debt just at its lower bound.

Interpreting this slow growth was one of the major challenges faced by the Federal Reserve last year. You may recall that, in establishing the ranges in February and reviewing them in July, the committee took note of the substantial uncertainties regarding the relationships between income and money in 1992. As we moved into 1992, there appeared to be an appreciable likelihood that unusual weakness in M2 growth relative to spending that had been experienced in 1991, would continue.

In the event, nominal GDP was even stronger relative to the broad aggregates in 1992 than seemed likely when their ranges were established. Income increased 3½ percent faster than M2 over the year and 4¾ percent faster than M3.

What accounts for this unusual behavior? Why is it that our financial system was able to support 5½ percent growth in nominal GDP with only 2 percent growth in M2 and ½ percent growth in M3? We can't be entirely certain we have all the answers, but certain elements of our evolving financial picture, which are detailed in the full testimony, clearly have played a major role.

A number of factors inducing savers to place funds outside M2, and borrowers to concentrate demands in long-term markets have accelerated a long-standing process of rechanneling credit flows outside of depository institutions. With reduced needs to fund asset growth, banks and thrifts have bid less vigorously for deposits.

As a result of such developments, the relationship between money and the economy may be undergoing a significant trans-

formation. If this is true, the liabilities of depository institutions will not be as good a gauge of financial conditions as they once were.

This is not to argue that money growth can be ignored in formulating monetary policy. The Federal Reserve in 1992 paid substantial attention to developments in the money supply, and we will continue to do so in 1993 and beyond. Selecting ranges for monetary growth over the coming year consistent with desired economic performance, however, is especially difficult when the relationship between money and income has become uncertain. Eventually, the monetary aggregates may resume a more stable relationship with the economy, or experience may suggest useful new definitions of the aggregates. But in the meanwhile, the Federal Open Market Committee necessarily has given less weight to monetary aggregates in the conduct of policy and has relied on a broad range of indicators of future financial and economic developments and price pressures. And in particular, the FOMC judged in 1992 that more determined efforts to push the aggregates into their ranges would not have been consistent with achieving the Nation's longer-term economic objective of maximum sustainable economic growth.

This use of a broad range of indicators is appropriate because achievement of the ranges for growth of particular measures of money and credit is not, and should not be, the objective of monetary policy. Rather, the ranges are a means to an end. The Humphrey-Hawkins Act, incorporating this view, does not require that the ranges be attained in circumstances in which doing so would not be consistent with achieving the more fundamental economic objectives.

In establishing ranges for the monetary and credit aggregates in the current year, the FOMC took into account the likelihood that many of the factors that have acted in recent years to restrain money and credit growth relative to income would continue, though perhaps with somewhat diminishing intensity.

The Federal Open Market Committee has elected to reduce the ranges for M2 and M3 for 1993 by  $\frac{1}{2}$  percentage point. For M2, a range of 2 to 6 percent measured, as usual, on a fourth-quarter to fourth-quarter basis, was established. A range of  $\frac{1}{2}$  to  $4\frac{1}{2}$  percent was specified for M3.

As I indicated in correspondence with members of the Congress, the Federal Open Market Committee does not view the reductions in the monetary ranges as signalling a change in the stance of monetary policy. And most emphatically, these reductions do not indicate a desire on the part of the Federal Reserve to thwart the expansion. The Federal Reserve, to the contrary, is endeavoring to conduct monetary policy in a way that promotes sustainable economic expansion. The lowering of these ranges does not imply any change in our fundamental objectives. The necessity for a reduction in the monetary ranges at this time is wholly technical in nature, and is a result of the forces that are altering the money-income relationship. Consistent with this view, the FOMC decided to maintain a range of  $4\frac{1}{2}$  to  $8\frac{1}{2}$  percent for domestic, nonfinancial sector debt, an aggregate whose relationship with nominal GDP has been less distorted in the last few years than that of the monetary aggregates.

Significant uncertainties regarding the appropriate ranges for monetary growth remain because the relationship between money and GDP growth could turn out significantly different from what currently seems likely. Accordingly, the Federal Reserve again will interpret the growth of money and credit relative to their ranges in the context of other indicators.

Mr. Chairman, several of the forces affecting relationships between money and income also complicate the task of assessing the economic outlook itself. For example, the prospects for an easing of supply restrictions on credit from banks and other intermediaries are difficult to assess, but any major change in this situation could have important implications for the economy.

Households and business are likely to remain cautious in using credit—a healthy development for sustained growth, but potentially continuing to constrain spending in the short run. Sizable imbalances in commercial real estate remain, and a significant rebound in this sector is doubtless several years off. Government spending at the Federal, State, and local levels is likely to remain constrained. A number of foreign nations are confronting slow economic growth or recession, which is likely to hold back demand for our exports. And it is apparent from recent announcements by several large firms that corporate restructuring is continuing.

While uncertainties thus remain, the economy appears to have entered the year with noticeable momentum to spending. In addition, inventories are at relatively low levels and factory orders have been rising. Consumer confidence has recovered and spending on durables and homes appears to be moving at a brisker pace. Recent surveys suggest an appreciable increase in business investment this year.

Against this background, members of the Board and Federal Reserve Presidents project a further gain in economic activity in 1993. The central tendency of our projections is for real gross domestic product to increase at a 3 to 3¼ percent rate this year. Such an increase should result in a decline in the unemployment rate, which would be expected to finish 1993 at a level of 6¾ to 7 percent. Inflation is expected to remain low this year.

Containing and, over time eliminating, inflation is a key element in a strategy to foster maximum sustainable long-run growth of the economy. As I have often emphasized, monetary policy, by achieving and maintaining price stability, can foster a stable economic and financial environment that is conducive to private economic planning, savings, investment, and economic growth.

It is no accident that the periods in our Nation's history of low inflation were the times when the economy experienced high rates of private saving, investment and, hence, productivity and economic growth.

Over the past decade or so, our Nation has made very substantial progress toward the achievement of price stability. As I have indicated to this committee on numerous occasions, price stability does not require that measured inflation literally be zero, but rather is achieved when inflation is low enough that changes in the general price level are insignificant for economic and financial planning. At current inflation rates, we are thus quite close to attaining this goal.

Going forward, the strategy of monetary policy will be to provide sufficient liquidity to support the economic expansion while containing inflationary pressures. Implementing this strategy, however, will be challenging. Judging the level of potential output and its rate of growth is difficult. Recent increases in productivity have been unusually strong, given the moderate pace of economic growth during much of the expansion, and it is unclear whether these rates of productivity gain can be continued. In addition, the monetary aggregates do not appear to be giving reliable indications of economic developments and price pressures, and numerous other uncertainties cloud the particular features of the outlook. Monetary policy will have to adjust to unexpected developments as they occur, taking into account a variety of economic and financial indicators.

The contributions that monetary policy can make to maximum sustainable economic growth would be complemented by a fiscal policy focused on long-term deficit reduction.

Mr. Chairman, in conclusion, I should like to make a few remarks on the most recent budgetary initiative.

Mr. Chairman, the President is to be commended for placing on the table for active debate the issue of our burgeoning structural budget deficit, which will increasingly threaten the stability of our economic system if we continue to fail to address it. Leaving aside the specific details, it is a serious proposal, its baseline economic assumptions are plausible, and it is a detailed, program-by-program set of recommendations as distinct from general goals.

It is obviously very difficult to get a consensus on deficit-cutting. If it were easy, it would have been done long ago. The debate among the Nation's elected representatives will be profoundly political, in the best sense of the word. As the Nation's central bankers, the primary and professional concern of those of us at the Federal Reserve is having the structural deficit sharply reduced, and soon.

Time is no longer on our side. After declining through 1996, the current services deficit starts on an inexorable upward path again. The deficit and the mounting Federal debt as a percent of gross domestic product are corrosive forces, slowly undermining the vitality of our free market system.

If we fail to resolve our structural deficit at this time, the next opportunity will doubtless confront us with still more difficult choices. How the deficit is reduced is very important, that it be done is crucial.

In this regard, there are certain issues that I have discussed with this and other committees of the Congress over the years which are worth repeating.

First, with current services outlays for 1997 and beyond rising faster than the tax base, stabilizing the deficit as a percent of nominal gross domestic product, not to mention a reduction, would require ever increasing tax rates. Hence, there is no alternative to achieving much slower growth of outlays. This implies not only the need to make cuts now, but to control future spending impulses. I trust the President's endeavor to rein in medical costs will contribute importantly to this goal.

Second, the hope that we can possibly inflate or grow our way out of the structural deficit is fanciful. Certainly, greater inflation

is not the answer. Aside from its serious debilitating effects on our economic system, higher inflation, given the explicit and implicit indexing of receipts and expenditures, would not reduce the deficit. As I indicated in testimony last month to the Joint Economic Committee, there is a possibility that productivity growth may be moving into a faster, long-term channel, boosting real growth over time. But even if that turns out to be the case, it wouldn't by itself resolve the basic long-term imbalance in our budgetary accounts.

Finally, fear that the deficit reduction can be overdone and create a degree of so-called fiscal drag that would significantly harm the economy, I find misplaced. In our current political environment, to presume that the Congress and the President would jointly cut too much from the deficit too soon is, in the words of my predecessor, nothing I would lose sleep over.

[Laughter.]

The Federal Reserve recognizes that it has an important role to play in this regard. In formulating monetary policy, we certainly need to take into account fiscal policy developments. But it is not possible for the Federal Reserve to specify in advance what actions might be taken in the presence of particular fiscal policy strategies. Clearly, the course of interest rates and financial market conditions more generally will depend importantly on a host of forces, in addition to fiscal policy, affecting the economy and prices. In any event, I can assure you, Mr. Chairman, of our shared goal for the American economy—the greatest possible increase in living standards for our citizens over time.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Chairman. Your reference toward the end of your supplemental statement about paraphrasing a predecessor about nothing you would lose sleep over, all of us in this room are, I suspect, employed and well paid and doing quite well and we're certainly not losing sleep over the fact that we don't have a job or that we're having difficulting supporting our families.

I can tell you out across the country, there's a great anxiety on the job front. We're here in the context of the Humphrey-Hawkins legislation, which is designed to try to make sure that we've got a broad employment base in the country. And there are a lot of people quite literally that are unable to sleep at night because they can't find work. They can't support their families. And increasingly, it's people with very significant job skills, people that have either been working in an industry, whether it's in aerospace or whether it's in heavy manufacturing, some with degrees in advanced computer science.

But there's a very large pool of unemployed people in the country, and even a larger pool of people who are under-employed, who can't find work really at the level at which they've prepared. And that's especially true of more and more of our college graduates coming out now. They train in a certain field. They sacrifice, take on college loans. Their families, in many cases, make a great effort to help them get through school.

They come out with degrees, very good, solid academic records, and can't find work in the field in which they've prepared.

So we've got a major problem of job shortage in the country. This has not been the kind of recovery, in a job sense, that we are accustomed to in the past.

Now in your statement today, you're saying that Fed policy anticipates and is essentially aiming monetary policy in the direction of a forecast that would show the unemployment rate somewhere between 6¾ and 7 percent by the end of this year. Is that right? I'm taking that off of page 20.

Mr. GREENSPAN. That is the projection of the Presidents and the Governors for that particular period.

The CHAIRMAN. The Presidents of the Federal Reserve Board.

Mr. GREENSPAN. The Presidents of the Federal Reserve Banks.

The CHAIRMAN. Yes, that's what I mean to say. As opposed to the President of the United States.

Mr. GREENSPAN. Correct. Although I must say, I gather from a document which I just picked up this morning, that our forecast does not appear to be appreciably different from the President's Council of Economic Advisers.

The CHAIRMAN. Well, I think that's the question and the question as to what new policies need to come into place to drive up job growth.

Will this forecast that the Federal Reserve has given us, would that give us something on the order of 2 million additional private-sector jobs this year?

Mr. GREENSPAN. It's difficult to say, largely because the forecast that we put in our text essentially is a survey of the 12 Presidents and the 7 Board Members. We do not ask for the detail underlying the forecasts. But I would presume there is significant growth in employment implicit in a forecast of that nature.

The CHAIRMAN. Well, with all due respect, I'm concerned about the answer because I think the focus of much of Fed policy, it gets spread out in such sort of a broad way, that I think it's easy to lose sight of the fact as to whether or not we're actually seeing private-sector job creation going on in the country.

And I think it's sometimes possible to run monetary policy in a way that leaves you with a very large pool of unemployed and underemployed workers that may not become the focus of the policy, that the policy may be aimed at other things and not necessarily at fully employing our people.

As I look at it, I think one of the ways that we could bring the deficit down is to have more people working, more people working, contributing, providing for themselves, paying taxes, and getting the job base expanding. But we're not seeing much of that. We're way short of the job recovery that we normally should see. We're about 4 million jobs short right now.

Mr. GREENSPAN. I don't disagree with the statement you've just made, Mr. Chairman.

The CHAIRMAN. But then the question is, in looking ahead, because this is really sort of a planning document. This is a forward look. What are we likely to see and what are the policies that we need that can support an improving picture?

I think we ought to be targeting our fiscal and monetary policies—you're here on the monetary side today—to see that that job growth is occurring, because I think if it doesn't occur, I think it

weakens the country, makes the deficit bigger. And I'm not sure that I'm hearing today in the planning and the projections of monetary policy, an objective, a goal to help drive up private-sector job growth.

I want to see the job growth in the private sector. I don't want to see it in the public sector. We may need some there as well. But I want to see the private-sector job base growing. And I'd like to see us crafting into our policies a specific strategy that's designed to help cause that to happen.

Now the President's laid out this whole plan that you and the rest of us who are here heard in the joint session the other night.

If that plan, something very close to that, were enacted, if that plan were to be enacted in terms of its overall sort of fiscal effect, and the timing and such, would the Fed feel, would you feel that you can support that plan with monetary policy initiatives so that the plan can work, so that we can get the job growth, 8 million jobs over the next 4 years?

Would that be a plan that the Fed could accommodate and work with and support with the complementary policies?

Mr. GREENSPAN. Mr. Chairman, remember that one of the advantages of monetary policy is that we can change fairly quickly, unlike fiscal policy. And, as a consequence of that, we don't have to have—in fact, it doesn't make terribly much sense to have—a long-term monetary policy other than making certain that we sustain a degree of price stability and financial stability which contribute to long-term growth.

What we would be doing, obviously, with our awareness of the changing fiscal policy as and when it evolves, is to be monitoring the situation exceptionally closely.

Not that we don't do that in general, but clearly, if there are a lot of elements involved which are changing the structure of the financial system, its interaction with the real economy, with the issue of jobs, then we have to find the means by which we can craft our monetary policy over the future in a manner which contributes to our ultimate goal, which is the endeavor to maintain the maximum sustainable economic growth in the economy.

With respect to the employment issue, I would like to recall remarks that you have made, and I think quite correctly in earlier discussions, namely, that we should be concerned not only with the level of job growth, but the types of jobs and the productiveness of those jobs and therefore, the real pay associated with those jobs in the future.

And so, while it is certainly the case that job growth has been deficient, and the figures you cite are quite telling with respect to the nature of what's going on in the economy, what is also occurring in the economy are developments which are quite sanguine, in the sense that we are seeing productivity growth moving fairly rapidly. And that is at least indicative that the real incomes of those who are employed are rising or will rise appreciably in the future.

And so, when we do get job growth occurring, as will be the natural consequence of a growth in the economy, I'm hopeful that the types of jobs that emerge will be the types of jobs that you in the past have so correctly indicated should be our goal.

The CHAIRMAN. Let me just say this. I very much want to follow up. I'm not going to do that. And what I want to do, and I will follow this rule strongly as we go down here because we've got a lot of members that want to participate.

I want to stay within the time limits on the question periods. If the Chairman is responding to a question when the light goes off, I want him to go ahead and finish. But I am going to not feel that we can do follow-ups any more than I can now, if we're going to stay within the time we have and give everybody a chance to get through maybe a couple of rounds here.

I don't want to be arbitrary about it, but I am going to use the lights here on that basis and I think it will be fair to everyone.

Senator D'Amato?

Senator D'AMATO. Thank you very much, Mr. Chairman.

I'm going to just make an observation, Chairman Greenspan. You said in your concluding statements, and I couldn't agree with you more, and I think everyone agrees with you, that the structural deficits are the area that has to be attacked. And if we don't address the structural deficits, we're going to be in deep trouble.

Well, doesn't it trouble you that spending between 1993 and 1997, has increased by \$117 billion—new spending?

Now how does that help reduce the structural deficit? And by the way, the next year it goes up an additional \$44 billion. So, doesn't that disburb you?

Mr. GREENSPAN. Well, Senator—

Senator D'AMATO. If it doesn't, tell me no. If it does, tell me yes.

Mr. GREENSPAN. Well, no, I needn't say either because one point I want to make here, and this will be relating to a number of the questions I'm certain will occur, is that I don't think I should be involved, nor do I intend to get involved, in the particular composition of the President's program. Let me tell you why. The Congress, the Senate and the House, and the President are now involved in a very crucial deliberation on something which is extraordinarily important to the future of this country. This is, as I said in my prepared closing remarks, a political debate in the best sense of the word. I don't think that those of us at the central bank, in our professional capacities, should be involved in this.

Senator D'AMATO. OK. I understand. The clock is running and then I'm not going to get to touch on something that I really wanted to touch on.

So I understand and I appreciate the sensitivity of your position and what you can and what you can't say and what you think is appropriate. But I will make an observation.

And that observation is that I don't know any economist or any banker who would tell you that if you want to deal with the structural deficit and if that's as crucial and as critical as you say it is, and you say, and I quote you, future spending must be reined in, that how, adding this kind of new spending on top of programs already there, is this going to help us achieve this reduction of the structural deficit.

It just isn't. It just isn't. And that's my observation. And I had trouble in economics 101. Senator Gramm, he was a professor in that, and so he will get into a major discourse.

But you don't have to be a professor to understand how it is that \$117 billion worth of new spending, and we call it an economic stimulus, is helping to reduce the deficit. And that's where people—now this is a political debate—that's where people have real problems, saying, you want me to raise taxes. You want me to pay more money.

I want it to go to deficit reduction and not investment by Government. All of a sudden, Government, we know what's best. We're going to invest for you. You give us your money, we're going to invest. Nonsense. You let the private sector, you let people do the investment and not a bunch of turkeys down here. OK?

That's where Alfonse comes from.

Senator GRAMM. Al, I want to change your grade in economics 101.

[Laughter.]

That's an A statement.

Senator D'AMATO. Thank you, Professor. I should have signed up.

[Laughter.]

Now, something on the positive side. Give me that statement over there.

You testified 2 weeks ago that, indeed, there was, and I'm paraphrasing now, that there was a credit crunch where small businesses have not been able to expand as much as in the past. It's a major reason why unemployment growth, which is largely a small business phenomenon, has been so tepid, and it is the reason why monetary policy has had to respond differently in certain respects, and particularly in economic cycles. You see, we still have a credit crunch.

That was 2 weeks ago in front of the Budget Committee. And you talked about why it is that this phenomenon does not exist in the home mortgage market because we created a secondary market.

We have introduced, and I'm not asking you to comment on the specifics of legislation which we just introduced yesterday, but basically, a bill which would lift the restrictions that inhibit a fuller participation in the secondary market as it relates to small businesses and making new loans available. In your view, would that be a beneficial kind of activity that we should undertake?

Mr. GREENSPAN. Yes, Senator, I think it will be. We do have a problem with the issue of securitizing small business loans because, unlike one-to-four-family home mortgages, they're not as homogenous.

Senator D'AMATO. So the rating of them would be——

Mr. GREENSPAN. It's a little more difficult, but the type of legislation, as I understand that you have offered will assist in that process. And there is no question that if we can find a way to create a secondary market of securitized small business loans, it would be very helpful.

Senator D'AMATO. One last aside, Mr. Chairman. I know the red light has gone on.

Mr. Chairman, we'll send over that legislation. Could you ask some of your people to work with our people in a bipartisan effort here, taking a look at it and point out any of the deficiencies that might exist?

I'm very enthused about it. I think it's the way to get credit out there to the small businesses.

I'd appreciate that.

Mr. GREENSPAN. I'll be glad to do it.

Senator D'AMATO. Thank you, sir.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Kerry?

Senator KERRY. Thank you very much, Mr. Chairman.

I'd might just point out in answer to Senator D'Amato's comment about increased spending, that revenue foregone, what we call tax expenditures, is a form of spending. Much of it has a very significant impact on business expansion, whether it's an ITC, targeted capital gains tax reduction, enterprise zones, IRA's, all things which our colleagues on the other side of the aisle I think support. That requires losing revenue which requires finding some alternative, does it not, Mr. Chairman?

Mr. GREENSPAN. Yes, it does, Senator.

Senator KERRY. I think you have said before this committee previously that you think many of those things would have an important, long-term growth incentive impact on our economy, would they not?

Mr. GREENSPAN. All aspects of fiscal policy, whether it be spending, so-called tax expenditures, taxation, all impact one way or another on the economy.

Senator KERRY. Have you not, I believe, on occasion, underscored the importance to this committee of some of the need for infrastructure investment and development as a means of also moving the economy?

Mr. GREENSPAN. No, I really haven't addressed that subject before this committee in any great detail. It's obvious that the aggregative infrastructure of a society is crucial to the development of economic activity and that in any market economy, one develops extraordinary interrelationships among the various segments of that economy. That clearly is a key factor in the productiveness of the system.

Senator KERRY. Understood. I'm confident what I'm hearing you saying is that, while you don't want to make choices about the specifics, nor should you, about the amount of spending cut or the amount of revenue raised, or the amount of tax expenditure or whatever, that you do feel that in the President's overall package and approach, he has laid out a fundamental structure that is important and necessary for us to deal with. Ultimately, as long as there is a balance between the revenues and spending, we can come up with a serious deficit reduction and a sound package.

Mr. GREENSPAN. The President has clearly put on the table a set of proposals which are quite specific and which can obviously be evaluated, and what is going to happen as a consequence, which is all to the good, is a very important debate in this country, especially in the Congress, on coming to grips with an issue which we can no longer allow to be put back on the shelf because, although for a number of years it didn't matter because it looked as though we would eventually find that the long-term deficit would decline and eventually disappear, in the last year or two, it's now becoming

evident that that is no longer the case and that we do not have the luxury of sitting around and hoping that it might go away.

However it is done, it is going to be very difficult, as everybody knows. It is going to create significant consternation on the part of innumerable numbers of people, and that is regrettably unavoidable because getting deficits down is not an easy task in a democratic society.

Senator KERRY. We all agree with that. All of us have looked hard at this budget, and I think if you are going to be honest about it, and we ought to be, you could eliminate all discretionary spending of the U.S. Government and you still have a deficit.

So I would ask you, Mr. Chairman, if it is your judgment that, in approaching this, that there is an inevitability in dealing with the current structural imbalance that we have, that some revenue—I'm not asking you for an amount, I'm not asking you for where. But do you accept the proposition that it is impossible to address this deficit appropriately without some revenue having to be found?

Mr. GREENSPAN. Senator, if you're asking me as an economist, the answer is no, you could, if one wanted to, deal with it strictly on the expenditure side. And I have testified before this committee on numerous occasions that, in my judgment, if one's basic purpose is to reduce the long-term deficit, it is more effectively done from the expenditure side than from the revenue side. But there are people who disagree with me on that and it's clearly a very significant political choice how that should be done.

So if you're asking me as an economist, then, as an economist, I'd have to say to you that the most effective way to reduce it is from the expenditure side. But that's obviously not the only consideration involved and fundamentally, the distribution of the budget is a very important political decision of the Congress and the American people.

The CHAIRMAN. Thank you, Senator Kerry.

Senator Gramm, who was now here earlier, has asked if he can come next in the order on your side and use his time period now. He may use it all for opening comment or he may ask a question. But he would go next on your side.

Is there any objection from any of the Republicans if he does that? And then we'll just go with the order back and forth.

Senator Gramm?

#### OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, I just wanted to make my opening statement. It's my understanding everyone else did.

Alan, I saw you in all of your splendor in the photograph in the paper between the First Lady and the Second Lady. People asked me who that handsome guy was and I said, it's Alan Greenspan, who controls the money supply of the United States. And had I been the President, I would have had you in exactly that same spot.

[Laughter.]

I want to express a discordant note this afternoon, and I don't express it based on the fact that the inflation rate was up sharply

in the last month. I think there are seasonal reasons that could dominate that figure in a one-month period.

But as I look at the President's budget proposal, recognizing that the lag between a policy change and the economy's response is, at a minimum, 14 to 16 months, probably 24 months, I am convinced that if the Clinton economic plan is adopted, we are going to have double-digit inflation within the next 4 years.

Let me explain why. Since your business is not debating politics, but is setting monetary policy, I think it's important to try to explain to you why I believe this.

First of all, I am hopeful that the President's plan will not be adopted, and I intend to do everything within my power to prevent it from being adopted. But as I look at it and as we now add up all the totals that are available, it is true that the President has nondefense cuts. In fact, he has a total of \$153 billion, when you take out the taxes like social security that are counted as spending cuts. But the problem is that he has \$164 billion of new spending programs. The cuts he proposes are basically one-time cuts, freezing salary increases, eliminating 100,000 jobs, which Ronald Reagan did in 1982, which Ronald Reagan did in 1983, which George Bush did once. Never, ever did they in fact happen.

The problem is when you add the new spending the President proposes, that total spending for nondefense purposes actually goes up \$13 billion above current services. The total level of revenues is \$313 billion of new taxes over a 5-year period. Defense is cut by \$187 billion. Defense and new taxes add up to 102 percent of deficit reduction.

It is going to be virtually impossible to cut defense any further at the end of this 5-year period and, in fact, at the end of 3 years, you're going to have made the big defense cuts.

Every one of these new programs being started is going to have a growth path. And the bottom line is, you're going to end up, if this budget is adopted, with no domestic spending restraint. In fact, spending is going to go up. You're going to have a massive tax increase on the people that make the investments, that create the jobs.

I am deeply concerned that what is going to happen is you're going to stifle the incentive to invest. I know our President believes that Government spending can substitute for it. In fact, we no longer call it spending. We call it investment.

My view is that cannot and will not happen, that these high marginal tax rates, these confiscatory taxes that we're imposing, the surcharge, 70 percent of it is going to fall on small businesses filing as subchapter S corporations.

I am concerned we're going to stifle the incentive to invest when this hits and it is felt about 2 years from now. We're going to have a new surge in spending as these new programs go into effect. We are going to have an adverse reaction in terms of international investment. We are going to have currency movement.

And I think one of the things we need to do in the midst of proposals to stimulate the economy in the short-term, is that we need to begin to look at the long-term implications of a massive tax increase, on top of not only no domestic spending cuts, but short-term

reductions that are more than offset by starting new programs that will have huge out-year growth.

I think there is a real potential danger here for a new wave of inflation. I hope I'm wrong, but I am beginning to be concerned that we are about to repeat the history of the 1970's. When Jimmy Carter came into office, the economy was improving. For 2 years, it was good, as the impact of prior economic policy played out.

But by the time the new policy took over, interest rates went up, inflation went up, and the economy was in the tank.

I'm very concerned about that and I wanted to share that concern with you.

The CHAIRMAN. Senator Bryan?

#### OPENING STATEMENT OF SENATOR RICHARD H. BRYAN

Senator BRYAN. Thank you very much, Mr. Chairman.

I want to shift the focus a bit. I understand that you're looking at things from a macro-economic point of view, but I want to talk specifically and spend a few moments in sharing what's really happening out there, and in particular, what's happening in my State.

We may debate here in Washington as to whether or not the credit crunch is real or imaginary, to use your terms, but there's no question out in my State, it's real. People who are legitimate business people, who have good credit histories, who have a long experience making the right kinds of judgments about investing and developing new businesses and expanding existing businesses, are simply unable to get the kind of capital to make those kinds of investments possible.

It's my view that, as a consequence of that, there has been, in our State, and I suspect nationally, an impeding of the economic recovery.

One of those businessmen brought a cartoon that I think best sums it up, and I would just share it with you and my colleagues. It pictures a national bank and there are some people gathered around the corner looking into the bank at the street corner.

A police officer is in view and he says, OK, folks, let's move along. I'm sure you've all seen someone qualify for a loan before.

[Laughter.]

Now that is pretty graphic and that tells the real story about what is happening out there in my part of America.

In point of fact, in my own State, bank loans have declined by 30 percent in the last year. That's almost double the nearest State. And I would share with my friend, Senator Bennett, that I have found the chart room in the limited time that I've been here, and I would show that to you.

[Laughter.]

That's Nevada on the end, 30.6 percent. The next State that would be affected by such a precipitous drop is Arizona.

Now I share that with you because, fortunately, Nevada is not an economic basketcase. Our economy is relatively strong. We've experienced continued growth, although the revenue growth hasn't been as rapidly expanding as in the 1980's, but it's still growing.

Two banks in our State, Bank of America and First Interstate Bank, have more than 80 percent of the bank market in Nevada. Last year, Bank of America reduced their business lending by 37

percent, and over the past 3 years, First Interstate Bank, the second of the large banks in Nevada, has cut back business lending by 73 percent.

Now it doesn't require a doctoral in economics, as my good friend from Texas has there, you don't have to be a rocket scientist to figure out what's happening to an economy when 80 percent of the banking market is, in effect, withdrawing from lending.

It's cost us a lot of job opportunities, a lot of entrepreneurial opportunities, lost profits, and economic growth.

I would hope that your staff would be taking a look at the specific impact.

Let me just mention one other aspect in the limited time that I have. And that is, I want to talk about small business lending in particular, and endorse and associate myself with the comments that the distinguished Ranking Member, Senator D'Amato, who, together with Senator Dodd, has worked on a piece of legislation which you've indicated that you're going to direct your staff to examine, and that's the securitization of small loans. I think that's going to be terribly important.

As the President pointed out in his comments in the State of the Union message, small businesses constitute a very substantial part of economic activity in our country. If they're not able to get the kind of capital they need to expand, we're going to continue to stall and sputter.

Now I've served on the committee since 1989 and I don't want to revisit the savings and loan fiasco.

My concern, however, is that the cure of the savings and loan fiasco not be the poison for the economic recovery of the 1990's. So I have concerns about this ongoing credit crunch.

Let me just point out one other chart that we have that indicates a trendline that is reflected I think nationally as well. And here is what's happening.

The blue line at the top, starting in 1989, the chart goes to the 1992 second quarter. There you see the business loan. Now this is Nevada. And you see what's happening with the banks in terms of their acquisition of Government securities for their portfolios.

In my judgment, that's not what a bank is all about. I guess I've got maybe just time for one question. Let me ask it. Is it your sense that this credit crunch is real or is it just anecdotal or apocryphal?

Mr. GREENSPAN. No, Senator, it is real and it is something which we have been struggling with for several years, in the sense that a not insignificant proportion of our motives, if I may put it that way, in bringing short-term interest rates down as far as we did was related directly to this phenomenon.

But it's fairly obvious that interest rates alone are not the cause of what the problem is. If one looks at the different elements involved, one element which is becoming increasingly evident as a factor here, at least in my judgment, is the extraordinary problems we're having in commercial real estate.

As I indicated to the Joint Economic Committee and the Senate Budget Committee several weeks ago, it appears, and I say appears because we really don't have any hard evidence, that the problems that have emerged are with the prices of commercial real estate and the difficulty of getting a viable market so that we know what

in fact commercial real estate collateral could be sold at. If we don't have a liquid market, commercial bankers with large amounts of collateral of that nature supporting different types of commercial and other loans are unsure as to what the position of their institution is because if they don't know if they can sell it immediately and at what price, they are not certain whether or not they are in a particularly solvent position or one that is slightly less so. And that's created a very significant amount of fear on the part of lending officers and their bosses, and has been clearly a factor involved in the lack of willingness to expand the bank and make loans.

One need only visualize how the market would be at this stage if there had not been this dramatic decline in commercial real estate values. I suspect that the willingness of banks to move forward on somewhat adventuresome, if not risky, types of lending would have been far greater than we have seen.

The fundamental purpose of a commercial bank is to make illiquid loans with risk. That's how they make their money. That's their franchise. That's their function in the economy. When they are frightened and concerned, as many of them have been, clearly, that has been a factor.

In addition, there's no question in my judgment that some of the regulatory pressures which we've imposed on the bankers has also been a factor. There are a number of other elements which we are currently looking at in conjunction with the new administration in an endeavor to find means to try to resolve this issue quicker than it's being resolved.

The only thing I can say is that the evidence suggests it's not getting worse and may be getting slightly better. But it undoubtedly is a major factor in the problems that small businesses have in their ability to finance their employment and product growth.

Senator BRYAN. Mr. Chairman, my time is up, but I would ask that you work with us in monitoring the situation in Nevada.

I understand that in some regions of the country, the commercial overhang in the commercial real estate market is extensive, and it would take some period of time to work through that inventory.

That's not true in our State and it's not true in other States. And this fear that you're talking about has been like a virus. It's spread all over and we have a serious problem in many parts of this country where those macro-economic factors are not in play in the sense that there is a demand, there is a need out there. But, yet, there is an inability to get the capital to make those kinds of investments to make our economy surge.

And I would hope that you and your colleagues would work with us in monitoring the situation in my own State when we have a chance for a follow-up visit.

Mr. GREENSPAN. Yes, Senator.

The CHAIRMAN. And it should be just noted for the record, too, before I call on Senator Faircloth, that the Federal Reserve has another role as a bank regulator. You do in fact regulate banks yourselves, a certain number of banks in the country.

While you're here commenting with your monetary policy hat on, you also, and your people are out there actually doing the supervisory work, the regulatory work over a very substantial part of the banking system.

Mr. GREENSPAN. That is correct.

The CHAIRMAN. And so, I think it's fair to just, in making that point, say that if there is something amiss in the process between the regulators and the banks, certainly within the area that you are the regulator of the banks that you regulate, that's something that you have, it's fair to say, very direct access to, isn't it?

Mr. GREENSPAN. We are acutely aware of that issue, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Faircloth?

#### OPENING STATEMENT OF SENATOR LAUCH FAIRCLOTH

Senator FAIRCLOTH. Thank you, Mr. Chairman. Thank you, Chairman Greenspan. It's an honor to have the opportunity to visit with you.

I was particularly intrigued by and excited, rather, by your statement that reducing spending was the way to bring us out of a deficit.

But one thing that's gone on, we've seen a number of charts, each one showing the decline in bank lending over the last several years.

Well, nobody's alluded to the fact that we have been in a recession, and in a recession, you borrow less money. Now I come to this table from a somewhat different background, in that I have spent my entire life in the private sector. I've got a payroll every Friday afternoon for 45 years and we'd better meet one this afternoon.

But in a recession, the demand for loans is down. I don't see this as a problem in North Carolina. We have some of the better and most aggressive banks in the country, as you're well aware. And they are certainly meeting the needs of any legitimate credit in that State. I just wanted to make that point.

But back to this reducing the deficit.

For the last 12 years—you could extend it for the last 40—but for the last 12, to pin it down, every time we've increased taxes a dollar, we've increased Federal spending \$1.55. And, as I say, this is a pattern that's gone on.

Do you really believe that the President's program will reduce the deficit? In a word, do you believe it will reduce the deficit, or are the American people being led down this path one more time to believe that something is going to happen that absolutely isn't, that we're going to see nothing but more inflation and more deficit? Do you really believe it will reduce it?

Mr. GREENSPAN. If one looks at the program as such, it is a credible program, in the sense that it's not vague. He is very specific. One can argue about the composition of what's involved there, and one can very readily argue, obviously, that if you enact it fully, whether in fact other forces might not overwhelm it, or there may be misestimations of various elements in the program which will cause it to veer off.

Having not looked at the extreme details—that we don't yet have—I must say that from what I have seen, this is a credible endeavor. Whether it succeeds or fails is going to depend very substantially on the disposition of the Congress.

I do think that one of the issues which has emerged which is probably extraordinarily important in this debate is the question of curtailing spending.

We all know, as I indicated in my remarks relevant to this question, it's an arithmetical question that if you have a current services expenditure budget which is rising faster than the tax base, the system in the long run cannot work.

The President is obviously aware of that fact. He has, as far as I can judge, endeavored to introduce expenditure cuts, and I suspect that he is looking for more, at least listening to the various notions and questions of his colleagues.

There is no doubt that the issue of health costs is going to be crucial to this question. But we are probably at the beginning of a very important debate in this country which I hope at the end will achieve a sustainable pattern of structural spending and receipts which no longer has this unstable bias in it.

It's going to be very difficult, but it's going to be extraordinarily important to this country's future and to the viability of the economic system if there is success at the end of the road here.

Senator FAIRCLOTH. I see that my time is running out, but I had one quick question that I want to ask you. Is it possible—I've asked this from a number of people and I haven't gotten an answer, and I'd like just is it possible—that by borrowing \$4 trillion, \$3½ trillion in the last 30 years, with this huge deficit we've been running, is it possible that we have led the American people to expect a higher standard of living than the productivity and the wealth of this country can continue to sustain, that we as a Government have led them to believe that there is a standard that we simply can't keep?

You're old enough, and I am, and you don't have to be very old to remember that 30, 40 years ago, the standard of living was a lot less and we got along pretty good. But have we pushed this propensity to consume to the extent that we're going to have to back up?

Mr. GREENSPAN. Senator, what economists would say in the same terms that you are is that we save too little, and that in saving too little, basically, we don't have the financial capabilities of creating a level of plant and equipment expenditures to move the standard of living up.

Fortunately, however, even though the amount of capital investment has been subnormal by either our historical standards or on an international standard, it turns out that the productivity of the capital that we have put in, largely as a consequence of our extraordinary capabilities in areas of technology, software applications, and the like, is apparently increasing.

I say apparently because it's much too soon to make the judgment. But what we're looking at is the importance of ideas as a form of capital and that, fortunately, we still have got and have been very assiduously applying in the last several years. That's the reason why we're getting, in my judgment, at least partly, such an extraordinary pattern of productivity despite the lackluster elements involved in this recovery out of the recession.

So I would not be overly concerned about the future. If we can keep this process going and improve our domestic saving in this

country, which is one of the reasons we want to get the budget deficit down, then the outlook looks to me a lot more hopeful than it looked fairly recently.

Senator FAIRCLOTH. Thank you, Chairman Greenspan. It's an honor to have you.

Mr. GREENSPAN. Thank you.

The CHAIRMAN. Senator Moseley-Braun?

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman both of you, Chairman Greenspan, and Mr. Chairman.

I'm new to this committee and I must say, I'm a little taken aback by all the references to the deficit and increased government spending when it seems to me we quadrupled the deficit over the last several years and we spent more money over the last several years.

Government spending went from \$591 billion to \$1.3 trillion, and we still didn't have the job growth and development that the people who I talk to are vitally concerned about.

So, without making a partisan political speech, Mr. Chairman I would very much like to ask you a question going to how we can create jobs in this country, how we can stimulate small and medium-sized businesses, because, really, that is where the action is when it comes to providing for the well-being of our people.

The job creation, really, as everybody knows, is the real basis for our prosperity, particularly our productive capacity. And the credit crunch that everybody has been talking about is one of the reasons, certainly not the only reason, but one of the reasons for lackluster job creation in our economy.

Without getting into why the credit crunch exists, it seems to me that there must be something that can be done about it. We have heard testimony in the last week that the mainstream financial institutions prefer to invest in treasuries than loan to the business that wants to get started, the new business, the minority business, the female business, the small business, on the one hand. And then we heard horror stories just the other day about these alternative financial institutions, if we can call them that, who price-gouge people and charge 22 percent interest. So that's not an option.

Somewhere in the middle, somewhere in the middle, small and medium-sized businesses haven't been able to find opportunities in the middle, if you will, to get access to capital.

So my question, and I will summarize by asking the question, and that is, what can the Fed do to ease the credit crunch as it pertains to small and medium-sized businesses, businesses that are not able to get loans from the mainstream financial institutions? What can you do to help with credit expansion, availability of credit to those kinds of job-creating entities at reasonable interest rates?

Mr. GREENSPAN. Senator, you're raising the crucial issue which confronts us. There's no doubt that the job problem which the Chairman has raised in his earlier remarks is really a small-, medium-sized business problem.

We have never had large job growth among our larger corporations. The vast majority of job growth occurs as companies begin, as they expand in their early stages, and they take on people.

When they get large, the percentage rate of growth in jobs is really quite small, as the data very clearly indicate.

One of the most frustrating things that I've had to face in recent years is this specific credit crunch problem, in the sense that it is very difficult to get around the fact that what we are dealing with is a number of lending officers who got badly burned in the latter part of the 1980's and the early part of the 1990's, having made innumerable loans which turned out to be nonperforming and which created very significant problems for their institutions.

So that what we have obviously observed is human nature functioning—I was going to say, at its worst—but it's human nature. People are pulling back because they're scared. They had essentially run into a serious problem. They were seen to have made bad loans and they've gone 180 degrees in the other direction.

They've overdone it, and the question is how do we bring them back, in a sense? And as I indicated, one of the issues which I'm beginning to suspect might be useful is that the commercial real estate market, which has undergone extraordinary trauma, has got to become more liquid.

I'm not saying that the prices of real estate have got to come back. I'm merely saying that there must be transactions and enough liquidity in the market so that if I'm a banker and I hold a piece of property as collateral for a loan and I want to sell that collateral, I know the price I can get and I can get it expeditiously. That will make me far more prone to be willing to take other risks.

But if I'm stuck with frozen real estate, I'm likely to be far more cautious. It's that which we've got to break.

Senator MOSELEY-BRAUN. But what can the Fed do? There's been some suggestions about secondary markets for commercial real estate.

Mr. GREENSPAN. That's correct. Exactly right. We have encouraged the RTC to increase its secondary market offerings to try to liquefy that market. We are engaged at the moment in conversations with the Treasury Department on ways to confront this particular credit crunch through a number of different methods and we are looking at real estate markets, looking at various aspects of regulation, looking at other elements involved in the supervision and structure to try to find ways in which this problem can ease.

Eventually, it will. People don't stay scared all the time. And there's no doubt, as a number of charts we have seen from the Senators indicate, that there's very substantial liquidity in the banks. They hold a very large quantity of Government securities, which means that when the attitudes begin to finally change, there is more than enough resources to finance small business. And the quicker that happens, the better.

But I must say to you, it is an issue which I have felt very frustrated with for several years because we've been pushing in a lot of directions, and the truth of the matter is we just haven't succeeded in getting very far.

We, I could say, have stopped the erosion and maybe we've made a little progress. Loans have been creeping up recently. The growth in Government security holdings by commercial banks has flattened out. They're no longer growing. But we're not anywhere near

where I feel comfortable in this area, and we'll just have to continue pushing.

Senator MOSELEY-BRAUN. Thank you.

The CHAIRMAN. Very good.

Senator Roth?

Senator ROTH. Mr. Chairman, in your opening remarks, you did state that, if I understood you correctly, that there is no alternative to cutting spending.

One of my concerns, as we address the problem we face here in Congress, is that the current proposal, as I understand it, would raise taxes 5:1 over spending cuts.

Back in the days of Reagan, I think it was 1982, there was supposed to be \$3 in spending cuts for every dollar increase in taxes. In 1990, it was \$2 in spending cuts for every dollar increase in revenue.

But now we're faced with a proposal that would raise taxes \$5 for every dollar cut in spending. I get that figure from the fact that the President proposed a net \$250 million increase in taxes, plus the \$20 billion that would be taxed on the social security for those in the higher income. And there would only be \$53 billion in net spending reductions.

Now, I understand you don't want to comment on specific plans, but my concern, as we hammer out a proposal in the future, what are the risks in relying primarily on raising taxes over spending? Why is it more critically important that we cut spending? What are the factors that we should be looking at as we try to evaluate these various proposals?

Mr. GREENSPAN. Senator, as I've said many times before this committee over the years, the reason I believe that it's far more efficient to cut spending if one's purpose is to reduce the deficit, is that there appears to be a greater tendency for deficit reduction to stick if it is from the expenditure side rather than from the tax side.

Now I hasten to say that the statistical evidence of that is controversial. It's very difficult to prove either side of the case.

But the reason I raise the issue is that since we as central bankers have a considerable concern about the total aggregate borrowing of the U.S. Treasury—that's where our interest is—I'm merely stipulating that, in my judgment, it is easier to get the deficit down and to stay down over the long run from the expenditure side than from the tax side.

That's the only issue that basically I am raising. I am not arguing relevant to the various different compositions of what the budget should look like or not look like. I'm merely raising the technical question as to where the probability of long-term reduction that sticks is highest. And that's the reason I raise that issue.

I might add, however, that it is important that when we talk about expenditure reduction, we are finding, and the debate that is emerging in the Congress is going to make this even more clear, that it is very difficult to cut spending when we get down to specific programs. It's easy for those of us who talk in global, macro terms to put out bottom-line balances, but there is a constituency under every single item in the Federal budget for anybody who has endeavored to try to squeeze it down.

When you get to the detail, it gets very difficult. And I must say that I have considerable sympathy for the new director of the Office of Management and Budget, who is saying that he'd like specific explanations of where spending should be cut because I do think that we're going to have a very difficult time in resolving this issue, and we are going to have to focus on every item in this budget, as I think the President clearly has.

I don't know the way it's coming out, but I must say I'm quite pleased, as I suspect the markets are, that this issue is on the table and that it is eventually going to get resolved and everyone suspects, at least the market suspects, in a positive manner.

The CHAIRMAN. Senator Mack?

Senator MACK. Thank you, Mr. Chairman.

I want to, Mr. Chairman, direct my question to you, not in your role as Chairman, but as an economist, again, focused somewhat on the President's package, but not necessarily in the specific.

There are reports that the fourth-quarter growth may be revised upward to 5 percent. In your testimony this morning, indicating that the growth rate through this year, somewhere between 3 and 3¼ percent.

Picking up on the statement by Senator Gramm a moment ago that the policy lag, 18, 24 months, a budget of \$1½ trillion, an economy running somewhere between \$5½ and \$6 trillion.

Is this the time to be adding additional stimulus, the old phrase that's been used, is it time to prime the pump?

Mr. GREENSPAN. Senator, the argument that the administration is making is that they consider that what they perceive they need is an insurance policy, so to speak, on the economic growth.

I must say that I don't consider the size of the numbers that they have in their budget to be particularly of concern to us. If it were a big number, I would tell you, it would really concern us. But what's in this budget are rather modest numbers, and while one may or may not agree, you certainly can't argue, at least I can't, that it's something which is of an order of magnitude which would have a significant impact on this economy.

Senator MACK. It's interesting that I hear both sides of this economic question coming from my colleagues on the other side of the aisle.

We heard earlier this morning the concern that this economy is kind of like a plane taking off. Those of us who spend a lot of time on planes know that that's a fairly critical period.

The question then goes to the other side of the ledger, if you will—is this the time, then, to be raising a substantial amount of taxes on a fragile take-off, a critical period in that take-off? I'd be interested in your response.

Mr. GREENSPAN. Senator, you say you want me to speak as an economist, but I am Chairman of the central bank.

Senator MACK. You can't blame me for trying, can you?

[Laughter.]

Mr. GREENSPAN. As I said earlier, I just don't think it is appropriate for any of us at the central bank to be involved in the debate which is in the process of emerging on the various priorities within the total budget system.

As I said, our concern is the end result, and we wish you well.

[Laughter.]

Senator MACK. One last try. What are most economists reporting to you as to what they think this may do to the economy?

Mr. GREENSPAN. I'll have them report to you directly, Senator.

[Laughter.]

Senator MACK. All right, I won't pursue it any further. Let me just go back to the credit crunch issue for a moment, and your response to Senator Moseley-Braun.

There was not a mention, at least I didn't hear it, as to what you think the role of pricing alternative investments, asset purchases on the part of the banking institutions.

Do you not think that a comptroller of a financial institution is analyzing the return on various choices for investment and has been concluding for some period of time that the bottom-line best investment for them to make is in treasuries?

Mr. GREENSPAN. It's a decision which is sort of a fall-back position. If they cannot find an immediate profitable loan to make, what they do is they tend to keep it basically in Government securities where there is liquidity.

But the profitability of organizations is very heavily skewed toward their ability to make loans because, even though there's been a lot of talk that somehow there's a great deal of deposit-taking invested in long-term U.S. Treasuries and there's a lot of money being made, I think that's an exaggerated view.

Bankers would like to make commercial loans if they felt safe in doing them and if they had a profitable activity.

Senator MACK. What role, then, do you think that regulation has to do with profitability?

Mr. GREENSPAN. To the extent, obviously, that regulation and various different elements of supervision affect the cost structure of a commercial banking institution, obviously, it has a direct effect.

And as you know, a number of the bankers are concerned that the rise in insurance premiums and other elements of cost that are associated with recent legislation have been a factor which has given them great concern.

Senator MACK. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Bennett?

Senator BENNETT. Thank you. I can't pass up the opportunity, with a world-class economist, to try once more.

[Laughter.]

I will not ask you for a value judgment, however. I'll ask you for a little education.

I spoke in my opening statement, or quoted in my opening statement, the comment from The New York Times that the President's proposal is geared in the in-years, the close years, to tax increases, and that the out-years will produce the impact of the spending cuts.

Now, if I might, I will turn to The Wall Street Journal and it does have a chart that tries to quantify the impact of the tax increase on various individuals. They talk about a young family, a retired widow, yuppies, and Mr. and Mrs. Big Bucks.

The one message that comes through to me, as a private investor, and one who would be concerned about his own tax circumstance, is that it appears that my way of sheltering myself against the impact of the tax increase is to acquire a great deal of debt.

The circumstances outlined here in the Journal, the examples outlined in the Journal, is that the people who don't have a lot of debt get hurt and that the people who do acquire debt have ways of bringing down their taxable income as a result of the increased interest payments and so on.

We all know that the economy is not a sum-zero game and that projections made today based on today's circumstances never work out because the economy is organic and constantly shifting and changing. The best economists are always surprised when the real numbers come in later on.

So, without asking for a value judgment, would you think that my analysis is correct; that is, that heavy reliance on taxes, assuming that that is correct from The New York Times, might cause an increase in debt on the part of individuals who have that kind of flexibility, and of course, the main tax bite will hit the individuals who do have the flexibility. What effect do you think that would have on the economy as a whole?

Mr. GREENSPAN. Obviously, as marginal tax rates go up, the availability of various different ways of trying to lower one's tax liability does bring the issue of debt onto the screen, so to speak.

I would be doubtful if it's a big issue, however. In certain cases, it might be important, but I can't see it as something which is likely to be moving at a level which would have macroeconomic implications.

Senator BENNETT. All right. Let's talk about imports for just a minute. Give me your opinion—or about world competitiveness.

Give me your opinion of the energy tax. The energy tax, of course, is more than a suburbanite driving into work and thereby paying a few more dollars a month, which he or she can easily absorb. It will also go on truckers. It will go on people who produce power. It will hit, possibly increase prices through the supermarkets and go through the economy with a ripple effect. We saw that, obviously, as a result of the oil shock in the early 1970's.

Have you done any studies or know of any studies about the impact of the energy tax, what it would do to the consumer price index? And would it have a ripple effect or would it, too, be negligible in macro terms?

Mr. GREENSPAN. It's inevitable that we will see fairly shortly a number of studies which are going to evaluate the exact impact of the President's proposal. They will be coming from, I assume, both the administration and a number of private economists.

I don't think that I would want to get involved in that because that gets into the issue of evaluating a specific policy discussion which the Congress is going to be involved with. And I would just as soon wait until I see some of the numbers.

Senator BENNETT. But it will have an impact one way or the other. It's up to us to decide whether it's good or bad, but you're saying that there will be one.

Mr. GREENSPAN. Certainly. Every action on the tax end or expenditure side has implications. The question is how does one evaluate them and how does one array them with respect to good or less good.

Senator BENNETT. Fine. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bennett.

Chairman Greenspan, in your supplementary statement, I want to follow up directly on a subject that others have touched on.

You say in your first paragraph, in responding now to the plan that the new President has put forward, you say, leaving aside the specific details, you say it's a serious proposal.

You then say its baseline economic assumptions are plausible. And you say it's detailed program-by-program set of recommendations, as distinct from general goals. I take that all to be positive observations. Is that fair?

Mr. GREENSPAN. Certainly.

The CHAIRMAN. Now, if we stay on the path we're on, we have these projections going out into the future of these explosions in Federal deficits. In fact, if I'm not mistaken, you talk about it in your opening statements, that the deficits are scheduled to get so huge and unwieldy, that they threaten really our whole economic future if we stay on the path we've been on. Isn't that correct?

Mr. GREENSPAN. That is correct, Mr. Chairman.

The CHAIRMAN. Now, I don't want to get you into the component parts of this plan. You've said that you don't want to do that and I respect that, so I will not ask you to do that.

I want to ask you a different question, though, that I think is an appropriate question within the purview of what I think you can reflect upon.

And that is, if we take a package of this size as a whole, if we take the overall financial consequence of this plan as it's been laid out—the deficit reduction, \$140 billion down by the time we get out through the 4-year period of time, certain spending cuts, certain investment items that are in there, both in the private sector and some in the public sector.

But leaving aside the balance within the mix, but just the overall numbers. If this plan, a plan of this size, with whatever adjustments, but a plan of this size is enacted and it, in fact, brings the deficit down that much over that time period, wouldn't that ease inflationary pressures over what they would otherwise be if we just continue to ride out on current trendlines?

Mr. GREENSPAN. Yes, sir.

The CHAIRMAN. So it would reduce inflationary pressures, would it not?

Mr. GREENSPAN. From what they otherwise would be.

The CHAIRMAN. Exactly.

Mr. GREENSPAN. And I want that emphasized because what we are looking at, as I indicated in my remarks, is something which I find very chilling—namely, that after the deficit goes down, largely because defense is going down, that it then starts to work its way back up.

The CHAIRMAN. And that's under existing policy if we do nothing.

Mr. GREENSPAN. Exactly.

The CHAIRMAN. Right.

Mr. GREENSPAN. And if we do nothing and that festers, then when we really have to get involved with it, it's going to be extremely difficult for this country.

I'm not saying it's easy now. It is obviously very difficult. And as this debate evolves, we're going to see how difficult it is. But we have no choice. We've got to turn that pattern of deficit, structural deficit, down or have some very severe consequences at the end of the day.

The CHAIRMAN. Well, I think that's an important observation. And so, leaving again aside as to how this program might be adjusted by the Congress, the give and take of what the items are, if we can in fact achieve a real deficit reduction off the baseline that comes down \$140 billion a year, that will actually reduce inflationary pressures over just continuing what we've been doing.

Mr. GREENSPAN. From what they otherwise would be.

The CHAIRMAN. Yes.

Mr. GREENSPAN. That's correct.

The CHAIRMAN. Now, isn't that in part—I mean, this is logic now, an observation, and you can't base anything on one day's sort of reaction in the markets. But I've been struck, for example, and it would sort of bear out, I think, that observation that you just made, that the long bond rates did drop after this plan was put on the table.

Now I don't say that that's the only item out there that's influencing psychology. But it seems to me that it is one very important barometer when the long-term bond rate of the effective interest rate comes down. I would think that that is in part a reflection of less concern about long-term inflationary pressure, as opposed to the reverse of that. Isn't that generally the case?

Mr. GREENSPAN. I would agree with that, Mr. Chairman. There is an increasing expectation within the market place, as I read it, that something will evolve out of the current debate, the end result of which will be a better long-term structural deficit outlook. And that clearly would be something which, if you're holding a 30-year U.S. Treasury bond, you would be very interested in.

I know that there are a number of different explanations as to why long-term rates have moved down recently, but the evidence strongly suggests that it's a growing awareness that we may be coming to grips with this issue for real.

The CHAIRMAN. I'm struck by the way you characterized it and I see it the same way.

In other words, people can disagree if they wish about elements of the plan. It is a serious plan, as you have said. I think the economic assumptions are plausible. It does constitute real deficit reduction over what we otherwise would have. And that does ease inflationary pressures and I think the markets are seeing that and we've already seen some response by the markets to that.

Now, if that is so and long-term rates were to come down and stay down over what they otherwise would be, doesn't that provide a certain economic benefit to our system?

In other words, doesn't that make it easier for a lot of things to happen, people to borrow, to invest in businesses or home mortgages or college loans or anything else? If we can get the interest rates down because we've got better fiscal discipline, doesn't that

give the economy a different kind of a booster shot because the cost of credit is lower and that makes more things that are productive possible?

Mr. GREENSPAN. I certainly agree with that, Mr. Chairman. What we have got is a particularly sensitive type of economy to that type of event because of the balance sheet problems that I mentioned in my prepared remarks.

Under any conditions, a decline in long-term interest rates, especially real interest rates, which would probably also decline even as inflation expectations decline, would give us far greater rates of return for long-term investment which are crucial to rising standards of living.

But in this particular period, if I could choose a single action or change a certain statistic in this economy which would give us the greatest economic thrust, I would say I would like to bring the mortgage rate down because that is symbolic of a number of relationships which would basically be far more powerful a stimulant than most anything else I can conceive of. And that's the reason why I think this budget deficit question is of such great moment.

The CHAIRMAN. Well, it seems to me the signal that this new plan, this serious new plan by the President has given, and I think as one measures the long bond market and it's about today where it was yesterday, but it has come down.

In other words, the effective interest rate dropped quite significantly in the trading period since that plan was put on the table. I take that as a positive sign from the market.

Obviously, if the long-term bondholders and buyers and sellers thought that there was a huge burst of inflation in this plan, one would have expected that the bond interest rate would have gone up. In other words, you would have seen a very different market reaction. We have not seen that.

And so, if we can get on a path, on a new path, balanced in this fashion that brings down long-term interest rates, there actually is a growth bonus that we can get.

Now you think it would come in the greatest measure if we could get home mortgages down. If we can get home mortgages down, I assume you see, then, the potential for more new home construction, people buying homes, and everything that can flow from that. Is that right?

Mr. GREENSPAN. It's not only that. There is the issue that if you get the real long-term interest rates down, the cost of capital of all types is down.

The CHAIRMAN. Exactly.

Mr. GREENSPAN. And so, it's not only residential construction. I might add it's commercial construction values which are important, not for new construction, but the value of existing commercial construction, as well as capital investment, which is a crucial and, in fact, necessary element in any program for long-term economic growth.

The CHAIRMAN. Just two other things and I'll yield to Senator SARBANES.

It seems to me that if inflation expectation actually, then, would come down, if we can get real deficit reduction in place, say the \$140 billion over the 4-year period of time over what it otherwise

would be, if we can get the real inflationary expectation down and interest rates then come down some, doesn't this also help the Federal Reserve, in a sense, with its policy latitude?

Don't you actually have more room with which to work and to help the economy get stronger if some of the pressure is taken off that way? Won't it work in that fashion?

Mr. GREENSPAN. Yes, of course it will. But let me just add one additional element to your comments, Mr. Chairman. The \$140 billion is for 4 years out.

The CHAIRMAN. That's right.

Mr. GREENSPAN. But remember that unless further cuts in the current services expenditure levels are not made in the years subsequent to that, even under the President's program, we have the deficit starting back up again. This is the reason why the President has correctly identified the health cost question as crucial.

The CHAIRMAN. Right.

Mr. GREENSPAN. But it is also important that we remember that the issue of restraining new programs has got to be there.

The CHAIRMAN. Right.

Mr. GREENSPAN. And Mr. Panetta has indicated, as well as Dr. Rivlin, that they are contemplating a structure which would create the types of enforcement mechanisms in the budget which will restrain that.

It's not going to be a simple task. It's going to be a task which is not complete with the President's program, even if it's adjusted as the Congress wishes to adjust it at the end of the day.

But what is going to be required is to confront the next period because it's not solely the next 4 years that matter. We are talking about 30-year bonds or 10-year mortgages, or what have you, in which the valuation of these instruments is well beyond the short-term period. And unless we come to grips with the total period, we will not get interest rates falling to sustainable low levels.

The CHAIRMAN. I think that's exactly right. And you've touched on it and we should just punch it up, I think. The health care reform, which is coming a little bit later—we don't have that program on the table, but a key element of which will be to contain the growth in health care costs—that is a central element in this whole business of restraining Federal Government expenditure growth and, for that matter, expenditure growth outside the Federal Government. It's bankrupting the States. It is a lot of private businesses, large and small, and families.

Mr. GREENSPAN. It's been a major factor, incidentally, in slow job growth as well because, obviously, the health costs have inhibited the taking on of new permanent employees.

The CHAIRMAN. So it would be fair to say that as that proposal comes forward within the matter of the next 2 months or so, that having that plan be tough and workable, whatever the internal details to contain these cost increases, is another critical part, in your view, of reducing inflationary pressure and getting our fiscal house in order. Is that right?

Mr. GREENSPAN. That's correct, Mr. Chairman.

The CHAIRMAN. Senator Sarbanes?

Senator SARBANES. Thank you very much, Mr. Chairman.

First of all, I want to underscore something that Chairman Riegle said right at the outset of the hearing. And that is the concern across the country with the issue of jobs.

We've not restored jobs in the recovery from this recession, in very sharp contrast with past recessions. The urgency of it, I think, is amply demonstrated by this cover on the latest Business Week—"Jobs, Jobs, Jobs: The Economy Is Growing, but Employment Lags Badly." And the story inside relevant to this cover is of course on this jobs issue and our inability to have the kind of economic growth and the restoration of jobs that's so necessary.

Now, Mr. Chairman, let me ask you this question. My perception of the plan that the President has put forward is that, aside from the year that we're in where there's going to be some supplemental, that its impact is essentially contractionary. Is that your perception?

Mr. GREENSPAN. Are you talking about the fiscal nature of the operation? I'd say that 3 or 4 years out, if in fact one literally—

Senator SARBANES. No, let's assume what he says happens. As Chairman Riegle said, it may not happen in the particular detail, but let's assume in the overall it happens.

Mr. GREENSPAN. If it happens precisely as it is programmed in the President's documents, at least those that I've seen, the answer is, yes, it is contractionary.

Senator SARBANES. Now, if you're concerned about having the economy expand, move forward, get some growth, get some job restoration, and if your fiscal policy is going to have a contractionary impact, which, in effect, would potentially put a downward pressure on the economy, where are we going to find the accommodation or the thrust for expansion for the economy?

Mr. GREENSPAN. It depends to a large extent on how the private sector responds. Obviously, if, as a consequence of the program, long-term interest rates fall further, say, then it's quite credible that you could essentially eliminate the fiscal drag effect by the effects of lower long-term interest rates so that, in that sense, one can either get somewhat less or even somewhat more stimulus from the so-called fiscal drag, meaning that when we talk about fiscal drag, we are talking only about the first moment, so to speak, of the activity.

But there are secondary consequences that occur and in many respects, in this type of environment, the secondary consequences of the fiscal drag are very positive. And indeed, it is not altogether out of the question that they could very well turn out to be far more stimulative than the size of the drag, if I may put it that way.

Senator SARBANES. I understand.

Mr. GREENSPAN. Now, granted, this is hypothetical because we are looking at very complex sets of relationships. But what I'm trying to get at, in response to your question, is that you cannot answer the question as to whether there is a net overall contractionary effect after one takes consideration of how the private system responds to that. You can't make that judgment very readily.

Senator SARBANES. Well, as I understand that, in effect, it means that it's possible that developments on what we ordinarily would call monetary policy, or on that side of the economic equation, could

provide the impetus for growth in the economy, even though the fiscal policy itself had a contractionary impact. Is that correct?

Mr. GREENSPAN. I wasn't referring to Federal Reserve policy, as such. I was talking about the market's response.

Senator SARBANES. Well, I know you're talking more broadly than that, but some of us think that you can impact on that.

Mr. GREENSPAN. Sure. I have no question that, obviously—

Senator SARBANES. We don't think you're completely helpless down there.

Mr. GREENSPAN. No, we don't think so, either.

Senator SARBANES. I didn't think you did. Well, given that, obviously, my perception is, we've got an economy that, it's almost like a plane trying to take off. It's trying to get up. It's really not got the kind of thrust that gives you the confidence yet that it will continue in an upward course. It could dip down again. We could have a triple dip.

That happened before. I remember you testifying, you expected it to go on up and then it didn't happen, and then it sort of came back down.

So it's starting to move. Clinton wants to give it an additional impetus, short-run, with his stimulus, which could be helpful. You've pointed out it's not large, I gather, in responding to some questions, in a dimension that causes you any concern or anxiety. But it could give it an additional boost.

Then this deficit reduction is going to weigh on to it, potentially pushing it down, although, if it's also getting a boost off the monetary side, it might be able to really fly with the deficit reduction. And, in fact, the deficit reduction may help it to get the boost on the monetary side and give it this kind of momentum.

But I've expressed concerns to you in the past, of course, about my apprehension that monetary policy not cut these efforts at a recovery off at the knees.

Now, given that, I was very interested to read your statement here today. I went out and got a cup of tea, in the hopes that it would enable me to read the tea leaves somewhat better than might otherwise be the case.

But I was interested in, for instance, where you say, the Federal Reserve, in formulating monetary policy, certainly needs to take into account fiscal policy developments.

Of course, I take it, obviously, if you think we need to sort of move the economy and if the fiscal policy is in a sense contractionary, potentially contractionary, if you were then to be very contractionary as well, wouldn't it sort of put a halt or stop to the progression of the economy?

Mr. GREENSPAN. It could. You mean out in 1995, 1996, when the cuts begin to grip, you mean?

Senator SARBANES. Well, yeah, or even sooner if you do it. I mean, some of this stuff is going to grip sooner than that.

Mr. GREENSPAN. It's very gradual. The early stages of this program are expansionary, not contractionary.

Senator SARBANES. Not for too long. Our analysis of it would have it—that the fiscal impact of the program is contractionary in fiscal 1994. The impact of the program is contractionary in fiscal 1994. So that it takes hold pretty quickly.

Mr. GREENSPAN. But it's not a deep squeeze, if I may put it that way. I agree with the general thrust, but it cumulates over time.

If you're asking me, in the abstract, if you were actually getting a fiscal squeeze which is not being offset by private sector demand and monetary policy turned tight, would that have a negative effect, of course, it would.

Senator SARBANES. I'm also encouraged by the statement—this is quoting you—I can assure you of our shared goal for the American economy, the greatest possible increase in living standards for our citizens over time.

Now, you note that inflation is low and should remain subdued. That leads me to this question. If that's the case, you also earlier made the comment that you could adjust monetary policy rather quickly, if you felt the need to.

It therefore seems to me that there's a margin here to be accommodating to try to help move the economy. If in fact you begin to see that you've overdone it, you're in a position to change fairly quickly.

I don't think at the moment we're anywhere close to that. We've got low inflation. We've got excess capacity. We've got a lot of people unemployed. We have an economic growth rate that is well below previous recovery periods. We have a President proposing a fiscal policy which is not in its overall impact expansionary, and the chance that I think that policy will be enacted. And therefore, I guess I'm really urging the Fed to accommodate this effort, to get this economy moving in terms of its monetary policy.

Now you've just had a meeting of the Open Market Committee, I think about 2 weeks, 3 weeks ago.

Mr. GREENSPAN. Yes, 3 weeks ago.

Senator SARBANES. When will the minutes or deliberations of that meeting be published?

Mr. GREENSPAN. The policy record will be published, I would suspect, in about 3 weeks from now.

[Pause.]

It's a little longer than usual. The policy record will probably be published March 26.

Senator SARBANES. Well, is that longer than is usually the case?

Mr. GREENSPAN. I think it is. Every once in a while, because of the way the calendar falls, the meetings are an extra week or something like that.

Senator SARBANES. You're obviously trying to read us and we're obviously trying to read you, I guess is fair enough to say. And we're going to have to start making decisions, including a budget resolution, here in the next few weeks.

I, for one, would have liked to have known in the course of deciding that what sort of indications there are from the Fed as to the monetary policy they're going to pursue, because, obviously, if we pursue a fiscal policy that is not—if, in our calculation, we say, we're going to try to expand the economy by an overall combination of what we do on the fiscal side and the monetary side. And in fact, we're looking to the monetary side to carry a good part of that burden so that we can have a tighter fiscal policy and get at the deficit problem, and then we turn around and discover that the monetary side is not going to play that role, then we could be in a very bad

situation because the economy could go soft again. Unemployment could rise. And that, of course, automatically would mean an increase in the deficit, would it not?

Mr. GREENSPAN. Yes.

Senator SARBANES. For those who want to reduce the deficit, they ought to have a shared interest in a strong, growing, vibrant economy.

Mr. GREENSPAN. I agree with that, Senator.

Senator SARBANES. Otherwise, a weak, anemic economy not only gives us a problem on the job front, which is, of course, a matter of first priority, but it also gives us a problem on the deficit front, by definition, almost. Isn't that correct?

Mr. GREENSPAN. That is correct.

Senator SARBANES. So there's nothing we can do about it. I don't expect the Fed, I guess, to change its practices right here and now, though, at some point, I think we probably ought to discuss what kind of interval ought to elapse from the meetings of the Open Market Committee before we have some sense of where the monetary policy is going.

But it's difficult, I think—I don't want to neutralize the use of fiscal policy to get economic recovery and jobs, on the premise or assumption that we're going to get an accommodating monetary policy to help us on that front, and then discover that the monetary policy card has been taken away from us.

And in fact, if that were to happen, from what you've just said, I take it you would perceive that would be undesirable if the consequence were to precipitate the economy downward. Is that correct?

Mr. GREENSPAN. That is correct, Senator.

The CHAIRMAN. Let me just raise a couple of other things. The hour is late. You've been very patient, and I'm mindful of that. I want to review one thing and then I want to go to the mortgage discrimination issue just very quickly.

Senator SARBANES. Mr. Chairman, before you do that, could I just put on the record a couple of things to finish up here?

The CHAIRMAN. Sure.

Senator SARBANES. I want to highlight this paragraph of the Chairman.

Going forward, the strategy of monetary policy will be to provide sufficient liquidity to support the economic expansion, while containing inflationary pressures. The existing slack—I take it you mean the existing slack in the economy—implies that the economy can grow more rapidly than potential GDP for a time, permitting further reductions in the unemployment rate, even while inflation is contained.

So that, as you see the situation, we, in effect, could pursue a course that would reduce unemployment, begin to pick up the slack, and yet, not raise an inflation problem. Is that correct?

Mr. GREENSPAN. That is correct.

Senator SARBANES. We'll be looking forward very carefully, Mr. Chairman. Thank you very much.

The CHAIRMAN. Just a final point on that. I gather from the discussion we've had back and forth today, and I want to make sure that we're exactly understanding one another, that if we take a

plan such as has been laid out here now, and its total economic effect—I mean, the numbers that are in there were to be enacted, with whatever changes shifting in and out of different pieces and parts.

But if, in total, it adds up, as this plan adds up now, you see that as easing inflationary pressures over what they otherwise would be if we just stay on the track we're on. You've stated that two or three times.

Wouldn't it be, then, fair to say that if we can do this, if we can have a package of this size and of this impact, won't that be a positive economic effect over staying with the course that we're on today?

Mr. GREENSPAN. You mean of getting the deficit down?

The CHAIRMAN. Yes, exactly.

In other words, if we have a package that has this fiscal impact, in this growth impact that's been laid out in terms of the numbers, isn't that a positive impact on the country as a whole and on the economy?

Mr. GREENSPAN. There's no question that if a fiscal policy is put together by the administration and the Congress which actually works to bring the budget deficit down, and especially, to bring the long-term track of the deficit down, there is no question that that is a very powerful, positive force for the American economy.

The CHAIRMAN. All right. Now, again, I want to stay out of the details of the package. I just want to take the numbers as they add up year by year and over the time period.

I take it that you're saying, and it's certainly my own view, that if we can get a package that has that same dollar amount of financial impact over that period of time, that that is going to give us this positive economic impact that you've just talked about.

Mr. GREENSPAN. As part of an ongoing process, if it appears that we are not attacking the longer-term issue beyond the 4 years, the problems will begin to re-emerge again.

The CHAIRMAN. I agree with that. We've talked about that. We've talked about the health care component, too, as a separate part and what goes beyond that.

But right now, I think the question is whether or not this program over this 4-year time period which is going to change these trendlines and get us started down in terms of the size of the deficit, as to whether we can get that in place.

And I take your testimony to be very clear, that if we can get a package of this size in place over that 4-year period of time, that's going to give us a positive economic effect.

Mr. GREENSPAN. Correct, provided, of course, that it actually works. In other words—

The CHAIRMAN. Well, of course.

Mr. GREENSPAN. —if it doesn't work, then we've got far more difficult problems.

The CHAIRMAN. We have that with everything. It's like monetary policy or anything else. We can have great policies, but they have to work.

Senator SARBANES. Could I add to Chairman Riegle's question the dimension that the President obviously feels very keenly about the health care issue. He feels keenly about it not only as a health

care question, but as an economic question because of its implications over the long run, and in fact, beyond this 4-year period.

So an essential part of the program he's putting forward, although that piece of it has not yet actually been worked out, he's to have health care reform of a sort that would control those trendlines beyond that 4-year period that you've been talking about.

Mr. GREENSPAN. Definitely.

The CHAIRMAN. Now, on the mortgage discrimination issue, I referenced earlier the study in October by the Federal Reserve Bank of Boston that indicated that, after all of the other legitimate credit-related issues were taken into account, that black Americans in that study were still 60 percent more likely to be turned down for home mortgage loans.

It's obvious that there is a serious discrimination problem there, as found by the Fed's own data.

What actions is the Fed taking now to try to put a stop to that and obviously, try to facilitate the proper flow of credit into these oftentimes, low-income, inner-city distressed communities?

Mr. GREENSPAN. We're spending a goodly amount of time on this issue because, as you stipulated earlier, it's the law. It's obviously a quite difficult issue, but I believe my colleague, Governor LaWare, will be testifying here next Thursday on a number of these and related issues, but particularly this. And he will outline for you the particular actions which we at the Federal Reserve Board are involved with with respect to this.

I also sent you along a memorandum, as I recall, from our staff, that provides answers to a number of questions which related to this. But Governor LaWare will outline in some detail where we stand.

He, incidentally, is the Governor with the longest service on the Committee of the Board which is directly related to this question.

The CHAIRMAN. Now we had a hearing earlier this week on this reverse redlining issue and some folks concerned about that have come down and met and talked with the Fed just this week.

This problem, of course, arises if people can't get mortgage credit through the normal banking channels because they're being discriminated against. Very often, they're pushed into these very high-priced kinds of loans that are really designed to take advantage of them and in many cases, cause them to lose their homes. We had a lot of illustrations of that where it's happened in practice.

Senator SARBANES. Very powerful and tragic statements. If you had been here to hear them, it was just—

Mr. GREENSPAN. A group of them came up to the Federal Reserve Board and I heard from my colleague, Governor Phillips, who met with them about a number of the issues that they raised.

The CHAIRMAN. When home mortgages or equity loans are being, in a sense, pushed toward people who are in tough economic circumstances and shouldn't be taking these loans, and they're 15, 18, 20, 22 percent, maybe 20 or 30 points on the front end, it's really an unconscionable practice. It appears to be quite widespread.

Finally, I just want to say, I think it would be constructive for the Federal Reserve to do some field hearings to get the issue of mortgage discrimination really out more fully into the light of day,

not to just go out for the sake of theater, but to make it clear what some of the practices are and why they have to be stopped.

I mean, I think there is a certain, based on the legal requirements, if nothing else, but there's a certain moral obligation as well for the Fed to give the kind of visible leadership in a way that helps bring an end to these discriminatory practices.

I think having the opportunity to let some of these issues get presented in a way where there is more attention to them, they are into the light of day, I think will serve as a kind of force for good. And I'd like to recommend that to you.

Mr. GREENSPAN. I must say, Mr. Chairman, that you're quite correct. It is an issue more than the law. This is not strictly a legal question; it is a moral question and it behooves us to function in a manner which obliterates this practice to the extent that we can unearth its existence and its causes.

The CHAIRMAN. Let me thank you for coming today. You've been very patient. It's very late in the afternoon.

Senator Sarbanes wants to make one final point, and then we're going to adjourn here.

Senator SARBANES. I wanted to make two points, actually, Mr. Chairman.

First is if you could pass the message to Governor LaWare that we're looking forward to his appearance here next week. We know he's been involved in this area and he has important responsibilities. We're anxiously awaiting his presentation and the opportunity to discuss the matter with him.

I do think Chairman Riegle has made a very positive and constructive suggestion here at the end. Maybe each of the regional banks could do a hearing for their region on this particular issue.

I had one question I wanted to put to you, Mr. Chairman.

I'm beginning to think that perhaps we need to reform certain aspects of Humphrey-Hawkins. When it was enacted some 15 years ago, monetarism was the vogue and we kept getting all these reports on money aggregates. You in fact say in your statement today, in the past few years, the broader aggregates in turn have become much less reliable guides for the conduct of policy.

I don't want to repeat the McCracken bulls-eye story here to you. You've heard it before.

Now you submit twice a year target ranges for money and credit, but only projections for output prices and unemployment. At a JEC hearing last week, I said I'm increasingly concerned that the use of these monetary aggregates as some kind of measure of policy really don't get what we need to know.

And I asked Jim Tobin, who was one of our witnesses, who of course worked very much in financial markets, about it, and he said, it's more important to have the Federal Reserve come to the Congress and express its goals for macro-economic performance about things that really matter. That's the growth of GNP, what happens to employment and unemployment, investment, the foreign balance, and inflation.

Now in light of this line of thinking, in light of the confusion caused by announcing monetary targets and then trying to explain why they are not being met, the difficulties I think here in the

Congress and in the public to understand and to debate the direction of monetary policy in terms of money growth targets.

What's your view to the idea that we should start giving attention or thought to moving away from targets for monetary aggregates and directly discuss targets for output and for prices and for employment?

Mr. GREENSPAN. Senator, I wouldn't necessarily abandon the monetary targets or the monetary aggregates now because, frankly, we're not sure that what we're going through is necessarily a permanent period of inadequacy as far as signalling is concerned.

Senator SARBANES. Let me amend the question, then. I don't necessarily have to abandon them. What about broadening it to include targets for output prices and employment?

Mr. GREENSPAN. I do think that it might be useful to engage in a dialog between myself, some of the people on the staff, and members of the committee and your staff and perhaps find a means by which we can address this particular question.

I did see your colloquy with Jim Tobin and I felt quite a good deal of sympathy with the general thrust of the discussion that was going on.

If we can find a way to be more helpful in conveying what it is that we're doing and why we're doing it to the committee, I think that that would be most useful.

Senator SARBANES. Thank you for that reply. We can work at it. Thank you very much.

The CHAIRMAN. Thank you very much. Thank you, again, Chairman Greenspan.

The committee stands in recess.

[Whereupon, at 1:25 p.m., the committee was recessed.]

[Prepared statements, response to written questions and additional material supplied for the record follow:]

## PREPARED STATEMENT OF SENATOR RICHARD BRYAN

Chairman Greenspan, I look forward to hearing your testimony. While I normally don't make opening statements, I would like to take a moment of the committee's time.

Last week, I held Senate Banking Committee hearings in Nevada on the credit crunch facing the small business community. Mr. Chairman, there may be a debate here in Washington as to whether there is a credit crunch, but I can tell the committee there is no debate in Nevada. There is a credit crunch and it is having a dramatic impact on businesses in my State.

I heard testimony from small businessmen—Sam Armstrong, a charter bus owner, Duane Hoover, a beer wholesaler, and others—who are upstanding citizen in my State and have excellent credit histories. When creditworthy individuals like these are being repeatedly turned down for business loans, I know there is a problem.

Bank loans in Nevada fell 30 percent last year—almost double the nearest State. Some of this may be attributed to accounting changes at Citicorp's credit card facility but the fact remains that bank lending in Nevada has suffered severe cutbacks.

Two banks, Bank of America and First Interstate Bank, have more than 80 percent of the banking market in Nevada. Last year, Bank of America reduced their business lending by 37 percent and, over the last 3 years, First Interstate Bank has cutback business lending 73 percent.

It does not take a rocket scientist to figure out that when 2 banks that control 80 percent of my State's business lending withdraw from the market, my State's businesses and economy are going to suffer.

This reduction has cost Nevada countless business opportunities and the well-paying jobs that come with business growth. Creditworthy borrowers simply cannot get funding to start new businesses or expand existing ones, build new homes, invest in plant and equipment or undertake other efforts that could get our economy moving again.

During the hearings last week, I was told that lending cutbacks were a result of the recession and too much regulation of the banking industry. While I will work to eliminate unnecessary banking regulations, Nevada banks should not be disproportionately affected by them. Nor can the recession explain what is going on in Nevada. In fact, Nevada was one of the healthiest economies in the Nation—job growth, ranks 5th and personal income growth, ranks 4th.

I am, therefore, left with the explanation that Bank of America and First Interstate Bank have undergone internal changes that forced them to dramatically shrink their loan portfolios. I am hopeful that these internal changes are behind them and that they will resume normal lending patterns. Each bank gave such a commitment at the hearings and I will be closely monitoring their progress.

Chairman Greenspan, I would appreciate your staff keeping me informed as you receive lending data from Nevada.

Beyond the specific problems with the major lenders in my State, I believe we must do more to help small business lending. That is why I have sponsored legislation with Senators D'Amato and Dodd to create a secondary market for small business loans. I urge this committee to take up this legislation at an early opportunity.

I was pleased to hear President Clinton point out in his State of the Union Address that small businesses have created a high percentage of all the new jobs in our Nation over the last 10 or 15 years. President Clinton went on to say that banks are not making sensible loans to small businesses, in part, because of Federal bank regulators.

Small business can only play the role of job creator if it can get capital. Small business is not risk-less business, nor is the banking business. The responsibility of the banking sector, and those who regulate it, must be to manage risk and to ensure the necessary flow of credit, while maintaining safety and soundness.

None of us want to repeat the S&L disaster of insolvency and taxpayer bailout. Yet, the cure to the S&L fiasco of the 1980's must not be allowed to poison the economy in the 1990's. The economy cannot recover so long as our financial institutions treat small business loans as some kind of pariah.

For the first time in more than 30 years, banks are taking customer deposits and putting more of them in Government securities than in commercial loans.

If this trend continues, our economy will be in serious trouble.

I commend to my colleagues to read the testimony from the Banking Committee hearings in Nevada last week. I am sure many of you are hearing similar stories from your constituents. I urge this committee to make legislation in this area a priority.

TESTIMONY BY ALAN GREENSPAN, CHAIRMAN  
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM  
FEBRUARY 19, 1993

Mr. Chairman and members of the committee, I appreciate this opportunity to discuss with you developments in the economy and the conduct of monetary policy. Nineteen ninety-two saw an improved performance of our economy. The expansion firmed, and inflation moderated. Some of the structural impediments to growth seemed to diminish. In particular, the financial condition of households, firms, and financial institutions improved. In addition, confidence rebounded late in the year.

Nevertheless, the expansion seemed to exhibit little momentum through much of 1992, unemployment remained high, and money and credit growth was sluggish. In response, the Federal Reserve took steps to increase the availability of bank reserves on several occasions. These actions brought short-term interest rates to their lowest levels in thirty years. Long-term interest rates also fell in 1992 and early 1993 as inflation expectations gradually moderated and optimism developed about a potential for genuine progress in reducing federal budget deficits.

Mr. Chairman, in the last few years our economy has been held back by a variety of structural factors that have not been typical of post-World War II business cycles—certainly not occurring all at once. These factors have included record debt burdens, overbuilding in commercial real estate, and a substantial cutback in defense spending. In this we have not been alone: Other major industrial countries also have been experiencing unusual impediments to growth, and by comparison the recent performance of the U.S. economy has been relatively good. Our monetary policy actions have been directed at facilitating adjustments to these developments and have in the process improved our economy's prospects for long-run sustainable growth. Significant hurdles, of course, still remain to be overcome in the short run. Nonetheless, in the view of the vast majority of business analysts, prospects appear reasonable for continued economic expansion and further declines in the unemployment rate. The tasks of the monetary and fiscal authorities alike will be not only to support this prospective growth but also to set policies to enhance the capacity of our economy to produce rising living standards over time. Before discussing the outlook in more detail, I would like to reflect on how monetary policy has interacted with the forces that have shaped developments over recent years.

### **Recent Economic Developments and Monetary Policy in Perspective**

I have often noted before this Committee the distinctly different nature of the current business cycle. A number of extraordinary factors contributed to the earlier weakening in the economy and have worked against a brisk and normal rebound from the recession.

Balance sheet restructuring has been, perhaps, the most important of these factors. In the 1980's, debt growth, hand in hand with rising asset prices, considerably exceeded that of income, and debt burdens rose to record levels. Debt-financed construction in the commercial real estate market was an extreme manifestation of this development, but it was apparent as well in other sectors of the economy.

That these imbalances developed should not be entirely surprising. The economy grew continuously for nearly eight years—from late 1982 through mid-1990, the longest peacetime expansion on record. In this unusual period of uninterrupted growth, unrealistic expectations of what the economy could deliver seem to have developed. In addition, households and businesses apparently were skeptical that inflation would continue to decline and, based on their experience during the 1970s, may even have expected it to rebound. As a consequence, many may have shaped their investment decisions importantly on expectations of inflation-induced appreciation of asset prices, rather than on more fundamental economic considerations. In the commercial real estate sector, assessments of profit potential formed during the first half of the 1980s simply went too far, leading to an unavoidable period of retrenchment.

The difficulties faced by borrowers in servicing their debts as the expansion slowed and the levelling out or decline in asset prices prompted many to cut back expenditures and divert abnormal proportions of their cash flows to debt repayment. This in turn fed back into slower economic growth. In addition, financial institutions were faced with impaired equity positions owing to sizable loan losses as well as more stringent supervision and regulation and demands by investors and regulators for better capital ratios. In response, they limited the availability of credit, with particular effects on smaller businesses. Over the last year or so, however, considerable progress has been made in strengthening balance sheets in both the nonfinancial and financial sectors. Moreover, by some measures the rate of deterioration of the

commercial real-estate industry might be slowing and prices in this sector may soon begin to stabilize. Such developments should contribute to the sustainability of the expansion in the period ahead.

Intensive business restructuring has been another important characteristic of the evolving economic situation. In an environment of weak demand and intense competition here and abroad, many firms have found it necessary to take aggressive measures to reduce costs. These actions have included selling or closing down unprofitable units and reducing their workforce. The process of restructuring has been given added momentum by the availability of new computing and communication technologies. Although these changes involve difficult adjustments in the short run, they are producing important gains in productivity, which will boost real wages and living standards over time.

The contraction in defense spending has been a third development restraining the expansion. Real federal defense expenditures dropped about 6 percent in 1992, and are down 9 percent from their 1987 peak. Those regions of the country with substantial defense-related activity have been among the areas whose economies have performed especially poorly. Although this development is having a contractionary influence on the economy in the short run, over a longer period the productive resources freed in this process will find employment in the private sector, contributing to capital formation and the growth potential of the economy.

Another, less-discussed factor that contributed to the formulation of our recent monetary policy dates not from the 1980s but rather from the 1970s—inflation and inflation expectations. Over the past decade or so, the importance of the interactions of monetary policy with these expectations has become increasingly apparent. The effects of policy on the economy depend critically on how market participants react to actions taken by the Federal Reserve, as well as on expectations of our future actions. These expectations—and thus the credibility of monetary policy—are influenced not only by the statements and behavior of the Federal Reserve, but by those of the Congress and the Administration as well.

Through the first two decades of the post World War II period, this interaction was patently less important. Savers and investors, firms and households made economic and financial decisions based on an implicit assumption that inflation over the long run would remain low enough to be inconsequential. There was a sense that our institutional structure and culture, unlike those of many other nations of the world, were alien to inflation. As a consequence, inflation premiums embodied in long-term interest rates were low and effectively capped. Inflation expectations were reasonably impervious to unexpected shifts in aggregate demand or supply. In those circumstances, monetary policy had far more room to maneuver; monetary policy, for example, could ease aggressively without igniting inflation expectations.

Even during the rise in inflation of the late 1960s and 1970s there was a clear reluctance to believe that the inflation being experienced was other than transitory; it was presumed that inflation would eventually retreat to the 1 to 2 percent area that prevailed during the 1950s and the first half of the 1960s. Consequently, long-term interest rates remained contained.

But the dam eventually broke, and the huge losses suffered by bondholders during the 1970s and early 1980s sensitized them to the slightest sign, real or imagined, of rising inflation. At the first indication of an inflationary policy—monetary or fiscal—investors dump bonds, driving up long-term interest rates. To guard against unexpected losses, investors now demand a considerable premium in bond yields—a premium that seems out of proportion to the likely future path of inflation, but one that nevertheless conditions the environment of monetary policy today. The steep slope of the yield curve and the expectations about future interest rates that it implies suggest that investors remain quite concerned about the possibility of higher inflation over the longer run, even as they appear less concerned about that possibility for the next year or two.

This heightened sensitivity affects the way monetary policy interacts with the economy. An overly expansionary monetary policy, or even its anticipation, is embedded fairly soon in higher inflation expectations and nominal bond yields. Producers incorporate expected cost increases quickly into their own prices, and eventually any increase in output disappears as inflation rises and any initial decline in long-term nominal interest rates is more than retraced. To be sure, a stimulative monetary policy can prompt a short-run acceleration of economic activity. But the experience of the 1970s provided convincing evidence that there is no lasting tradeoff between inflation and unemployment; in the long run, higher inflation buys no increase in employment.

This view of the capabilities of monetary policy is entirely consistent with the Humphrey-Hawkins Act. As you know, the Act requires the Federal Reserve to “maintain long-run growth of the monetary and credit aggregates commensurate

with the economy's long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

The goal of moderate long-term interest rates is particularly relevant in the current circumstances, in which balance sheet constraints have been a major—if not the major—drag on the expansion. The halting, but substantial, declines in intermediate and long-term interest rates that have occurred over the past few years have been the single most important factor encouraging balance-sheet restructuring by households and firms and fostering the very significant reductions in debt service burdens. And monetary policy has played a crucial role in facilitating balance sheet adjustments—and thus enhancing the sustainability of the expansion—by easing in measured steps, gradually convincing investors that inflation was likely to remain subdued and fostering the decline in longer-term interest rates.

That is the background against which we have conducted monetary policy for the last several years. Through this period, Federal Reserve policy was directed at fostering sustainable growth in the economy. Recognizing tendencies for the economy to slow, the Federal Reserve began to ease monetary policy in the spring of 1989. In response to the downturn that began in August 1990, we accelerated the reduction in short-term interest rates. Last year, we extended our earlier reductions in interest rates by lowering the federal funds rate another percentage point through another cut in the discount rate and injections of a large volume of reserves. In addition to reducing interest rates, the Federal Reserve lowered reserve requirements last year for the second time in eighteen months to help reduce depository institutions' costs and encourage lending.

Although the easing actions over the past few years have been purposely gradual, cumulatively they have been quite large. Short-term interest rates have been reduced since their 1989 peak by nearly 7 percentage points; looked at differently, short rates have been lowered by two-thirds. Some have argued that monetary policy has been too cautious, that rates should have been lowered more sharply or in larger increments.

In my view, these arguments miss the crucial features of our current experience: the sensitivity of inflation expectations and the necessity to work through structural imbalances in order to establish a basis for sustained growth. In these circumstances, monetary policy clearly has a role to play in helping the economy to grow; the process by which monetary policy can contribute, however, has been different in some respects than in past business cycles. Lower intermediate- and long-term interest rates and inflation are essential to the structural adjustments in our economy and monetary policy thus has given considerable weight to helping such rates move lower.

Some have suggested that the decline in inflation permitted more aggressive moves and, had the downward trajectory of short-term interest rates been a bit steeper, that aggregate demand would have been appreciably stronger. I question that as well. Basing this argument on the lower inflation that has occurred is a *non sequitur*; the disinflation very likely would not have occurred in the context of an appreciably more stimulative policy, and such a policy could have led to higher inflation in the next few years. Moreover, such a policy would not have dealt fundamentally with the very real imbalances in our economy that needed to be resolved before sustainable growth could resume. And it would have run the risk of aborting the process of balance sheet adjustment before it was completed. The credibility of non-inflationary policies would have been strained, and longer-term interest rates likely would be higher, inhibiting the restructuring of balance sheets and reducing the odds on sustainable growth.

Recent evidence suggests that our approach to monetary policy in recent years has been appropriate and productive. Even by last July, when I presented our mid-year report to the Congress, some straws in the wind suggested that the easing of monetary policy to that date and the various financial adjustments underway in the economy were proving successful in paving the way for better economic performance. Households and businesses appeared to have made significant progress in shoring up their balance sheets; considerable reductions in debt servicing requirements had been achieved, equity had risen, and liquidity was higher. In the financial sector, bank profitability had improved, and a brisker flow of bank earnings as well as issuance of new equity shares and subordinated debt had bolstered capital ratios, helping to arrest the tightening of lending terms and standards. The lower level of interest rates, both short- and long-term, helped to limit the decline in real estate values and boost the profitability of thrift institutions, as a byproduct reducing the losses that would have been borne by the Resolution Trust Corporation and, ultimately, the taxpayer.

It is now apparent that our July expectation of a firmer trajectory of output has been borne out. GDP growth is estimated to have picked up to a 3½ percent rate during the second half of 1992, following a more modest increase in the first half. Beginning in the late summer, some quickening in the pace of auto sales could be detected, and spending on other consumer durables strengthened as well. Single-family housing starts rebounded. Industrial orders, production, and shipments all rose. In association with this stronger trend, payroll employment growth has picked up and the unemployment rate has dropped back to 7.1 percent by early this year—certainly too high, but well below the level at mid-year. For 1992 as a whole, real gross domestic product is currently estimated to have increased at about a 3 percent rate. And indications are that the expansion is continuing in the early months of 1993, though perhaps at a slightly reduced rate.

The news on inflation in 1992 likewise was quite encouraging. The consumer price index rose just 3 percent in 1992, at the lower end of the central tendency of our July projections. Excluding volatile food and energy prices, inflation last year was the lowest in two decades. Although the January CPI was surprisingly high, judging from survey evidence and the behavior of long-term interest rates, inflation expectations appear to be gradually diminishing, as market participants gain more confidence that inflation is being contained.

### Money and Credit in 1992

These favorable outcomes occurred despite slow growth of the money and credit aggregates. The Federal Open Market Committee had established ranges of 2½ to 6½ percent for M2, 1 to 5 percent for M3, and 4½ to 8½ percent for domestic non-financial sector debt. Over the year, M2 actually rose 2 percent, M3 ½ percent, and debt 4½ percent. Thus, both of the monetary aggregates finished the year about ½ percentage point below their ranges, and debt just at its lower bound.

Interpreting this slow growth was one of the major challenges faced by the Federal Reserve last year. You may recall that, in establishing the ranges in February and reviewing them in July, the Committee took note of the substantial uncertainties regarding the relationships between income and money in 1992. Although the velocity of the broad monetary aggregates—the ratio of nominal GDP to the quantity of money—had not changed much in 1991, that result itself was surprising. In the past, when market interest rates declined, as they had in 1991, savers shifted funds into M2, since deposit rates usually did not fall as much as market rates, and this produced a decline in velocity, in contrast to what occurred in 1991. As we moved into 1992, there appeared to be an appreciable likelihood that unusual weakness in M2 growth relative to spending would continue. But, in the absence of convincing evidence for increases in velocity, the FOMC elected to leave the ranges unchanged from the previous year, noting that it would need to be flexible in assessing the implications of monetary growth relative to the ranges.

In the event, nominal GDP was even stronger relative to the broad aggregates in 1992 than seemed likely when their ranges were established. Income increased 3½ percent faster than M2 over the year and 4¾ percent faster than M3. The unusual nature of these increases in velocity can be illustrated by noting that, prior to 1992, the velocity of M3 had risen more than 3 percent in a year only once; the historical increases in M2 velocity comparable to last year's occurred solely in the context of sizable increases in market interest rates, in contrast to last year's declines.

What accounts for this unusual behavior? Why is it that our financial system was able to support 5½ percent growth in nominal GDP with only 2 percent growth in M2 and ½ percent growth in M3? We can't be entirely certain we have all the answers, but certain elements of our evolving financial picture clearly have played a major role. The most important, perhaps, was that savers believed they could earn considerably more on their funds if they were invested in something other than the deposits and money market mutual funds that make up M2. The unprecedented steepness of the yield curve was one factor contributing to the apparent rate disadvantage of M2 assets. The high level of long-term yields relative to shorter-term rates—rates on deposits, in particular—has attracted funds from bank and thrift deposits into alternative, longer-term investments. For example, bond and stock mutual funds, which are not included in our standard monetary measures, flourished in 1992. Assets in those funds, excluding institutional holdings and IRA and Keogh accounts, increased \$125 billion. In the absence of such growth, a sizable proportion of the additional shares doubtless would have resided in deposits. Shifts from deposits to mutual funds have been abetted by the spread of facilities in banks and thrifts to sell mutual funds directly to their customers.

In addition, the high relative cost of consumer debt, which has resulted partly from the elimination of the tax deductibility of consumer interest expenses, no doubt has prompted households to use funds that otherwise would be held in M2 to pay

off, or avoid taking on, consumer debt. Mortgage interest rates also are high compared with interest rates on deposits, reflecting the steep yield curve. This relationship has led some households to repay mortgage debt with funds that might otherwise be held in deposits.

Of course, if banks and thrifts had been expanding their loan portfolios, they would have had to bid more vigorously for deposits. But a number of developments damped growth of bank and thrift credit, and depositories consequently have been prompt to reduce rates on deposits. In the business sector, the higher levels of stock and bond prices have encouraged many corporations to pay down bank debt with the proceeds of a large volume of bond and stock offerings. More generally, the attitudes of households and firms toward debt and leverage appear to have changed considerably in recent years, perhaps in part mirroring revised expectations about prospects for inflation to ease debt burdens or reward leverage.

The supplies of credit by depositories also have been constrained. Incentives to lend have been damped by market and regulatory pressures for depository institutions to increase capital ratios, as well as by other factors raising their costs of intermediating credit, such as higher deposit insurance premiums, rising regulatory costs, and more stringent supervisory oversight. As a result, banking and thrift institutions have sought to limit balance-sheet growth or actually to shrink.

Together, these supply and demand factors have accelerated a long-standing process of rechanneling credit flows outside of depository institutions. With reduced needs to fund asset growth, banks and thrifts have bid less vigorously for deposits, as can be observed in the very low returns on such instruments. These low yields, as I have noted, provide incentives for depositors to redirect cash toward alternative investments and repayment of debt. In addition, the proceeds of banking firms' offerings of equity shares and subordinated debt have substituted for banks' deposit funding and have thus reduced monetary growth.

The adjustments in our depository sector have significant implications for the overall operation of the financial system and the performance of the economy. Historically, banking institutions have played a critical role in financing small- and medium-sized businesses—firms that in the past have been a key source of growth in the economy. Some of the factors leading to the relative shrinkage of our banking industry, by limiting the availability of credit to smaller firms, have restrained aggregate demand and thus have significantly hindered the economic expansion.

Nevertheless, the financial markets have shown a remarkable capacity to adjust to the contraction of the depository sector in a way that mutes the impact on the overall economy. For instance, despite a massive contraction in the thrift industry since 1988, housing credit has remained readily available and, in fact, relatively inexpensive as a result of the further exploitation of financial innovations such as mortgage-related securities. Similarly open market sources of funds have flourished in recent years, allowing many firms to tap the stock or bond markets to restructure their balance sheets.

As a result of such adaptations, the relationship between money and the economy may be undergoing a significant transformation. In contrast to earlier work that suggested a stable long-run relationship between M2 growth and inflation, recent developments may indicate that the velocities of the broader monetary aggregates are moving toward higher trend levels. It may be that the opening of securities markets to increasing numbers of borrowers and lenders—in part through securitization of loans by depositories as well as their offerings of mutual funds to deposit customers—is permanently shunting financing around depository institutions. If this is true, the liabilities of these institutions will not be as good a gauge of financial conditions as they once were.

This is not to argue that money growth can be ignored in formulating monetary policy. The Federal Reserve in 1992 paid substantial attention to developments in the money supply, and we will continue to do so in 1993 and beyond. Selecting ranges for monetary growth over the coming year consistent with desired economic performance however, is especially difficult when the relationship between money and income has become uncertain. Recent experience suggests that, at least for a time, measuring money against such ranges may lead to erroneous conclusions regarding the stance of monetary policy.

The shortfall of the aggregates from their ranges and suggestions that the Federal Reserve should have been more vigorous in preventing the shortfall have raised the general question of the role of the ranges in conducting monetary policy. The annual ranges for money and credit growth can be useful in communicating to the Congress and the public the Federal Reserve's plans for monetary policy and their relationship to the country's broader economic objectives. Lowering the ranges during the 1980s, for instance, served as an important signal of the anti-inflationary commitment of the Federal Reserve.

In some circumstances, the monetary aggregates can also be of value by serving as indicators of the thrust of monetary policy. Deviations of money growth from expectations may well signal that policy is not having its intended effect, and that adjustments should be considered. Over much of our nation's financial history a number of measures of the money supply had reasonably predictable relationships with aggregate income. The period of rapid financial change had not yet begun, and measuring money was more straightforward. Recognition of these predictable money-income relationships was the basis for the Federal Reserve's increased emphasis on money in the 1970s and the subsequent Humphrey-Hawkins legislation. And at the beginning of the 1980s, the Congress passed the Monetary Control Act and the Federal Reserve adopted procedures to provide greater assurance that targets for M1 could be achieved.

But, even by the mid-1970s, the relationship of the monetary aggregates to the economy was becoming more complex. Financial innovation and deregulation significantly altered the spectrum of available transaction and saving instruments. In the mid-1970s, advances in corporate cash management techniques, such as sweep accounts, reduced the need for business demand deposit balances for any given level of transactions. And in the early 1980s, the widespread availability of NOW accounts—transactions accounts that pay interest—led households to treat their checking accounts to some degree as savings instruments and to shift funds in and out of such accounts mainly on the basis of interest rate relationships. Such developments primarily affected M1. The FOMC made repeated adjustments to its M1 range to take account of changing velocity and soon after the mid-1980s had eliminated its target for this aggregate. Many of the shifts were captured within the broader aggregates, but adjustments to their ranges also had to be made from time to time.

In the last few years, the broader aggregates in turn have become much less reliable guides for the conduct of policy. Eventually, these measures may resume a more stable relationship with the economy, or experience may suggest useful new definitions for the aggregates. We are currently investigating several possible alternative measures. But, meanwhile, the FOMC necessarily has given less weight to monetary aggregates in the conduct of policy and has relied on a broad range of indicators of future financial and economic developments and price pressures. And, in particular, the FOMC judged in 1992 that more determined efforts to push the aggregates into their ranges would not have been consistent with achieving the nation's longer-term economic objective of maximum sustainable economic growth. Indeed, had there been an attempt to force M2 and M3 toward the middle of their ranges, intermediate- and long-term rates by now might have been significantly higher than they are currently, threatening the durability of the expansion.

This use of a broad range of indicators is appropriate because achievement of the ranges for growth of particular measures of money and credit is not, and should not be, the objective of monetary policy. Rather, the ranges are a means to an end. The Humphrey-Hawkins Act, incorporating this view, does not require that the ranges be attained in circumstances in which doing so would not be consistent with achieving the more fundamental economic objectives.

### **Ranges for Money and Credit for 1993**

In establishing ranges for the monetary and credit aggregates in the current year, the FOMC took into account the likelihood that many of the factors that have acted in recent years to restrain money and credit growth relative to income would continue, though perhaps with somewhat diminishing intensity. The yield curve could well remain steep, absent very marked progress in deficit reduction or a distinct break in long-term inflation expectations, which would tend to lower long-term interest rates. Banking and thrift institutions are unlikely to step up the pace of balance-sheet expansion sharply, and the large volume of securities they have accumulated in recent years will allow them to fund a pickup in loan growth without as marked an acceleration of deposit growth. And households and firms are expected to continue to be relatively cautious in their use of credit. Other factors may add to tendencies for money to expand more slowly than income. For example, a resumption of resolutions by the Resolution Trust Corporation, which has been inactive for nearly a year, by shifting assets from thrifts onto government balance sheets, would tend to substitute federal liabilities for those of thrift institutions, reducing monetary growth.

Reflecting the expectation that sluggish monetary growth will be associated with sustainable expansion in the economy, the Federal Open Market Committee has elected to reduce the ranges for M2 and M3 for 1993 by one-half percentage point. For M2, a range of 2 to 6 percent, measured as usual on a fourth-quarter-to-fourth-quarter basis, was established. A range of ½ to 4½ percent was specified for M3.

As I have indicated in correspondence with members of the Congress, the FOMC does not view the reductions in the monetary ranges as signalling a change in the stance of monetary policy. And most emphatically, these reductions do not indicate a desire on the part of the Federal Reserve to thwart the expansion. The Federal Reserve, to the contrary, is endeavoring to conduct monetary policy in a way that promotes sustainable economic expansion. The lowering of these ranges does not imply any change in our fundamental objectives. The necessity for a reduction in the monetary ranges at this time is wholly technical in nature, and is a result of the forces that are altering the money-income relationship. Consistent with this view, the FOMC decided to maintain a range of 4½ to 8½ percent for domestic non-financial sector debt, an aggregate whose relationship with nominal GDP has been less distorted in the last few years than that of the monetary aggregates.

Significant uncertainties regarding the appropriate ranges for monetary growth remain. While we have made some progress in understanding the behavior of the money and credit aggregates over the past year, to a degree this increased understanding has reinforced our appreciation of the complexity—and limited predictability—of the economic and financial relationships that affect money growth and its linkages with the economy.

These uncertainties imply that the relationship between money and GDP growth could turn out significantly different from what currently seems likely. Accordingly, the Federal Reserve again will interpret the growth of money and credit relative to their ranges in the context of other indicators of the financial system, the performance of the economy, and prices. Should recent trends affecting the money-income relationship continue, growth of the monetary aggregates in the lower portions of their ranges might be expected. On the other hand, the upper ends of the ranges provide ample room for adequate monetary growth should demands for money relative to income come more into line with historical patterns. In any event, until the relationship between the monetary aggregates and spending returns to a more reliable basis, flexibility in the interpretation of the aggregates relative to their new ranges is required.

### **Economic Outlook for 1993**

Several of the forces affecting relationships between money and income also complicate the task of assessing the economic outlook itself. For example, the prospects for an easing of supply restrictions on credit from banks and other intermediaries are difficult to assess, but any major change in this situation could have important implications for the economy. While banking institutions have become much more healthy and are well-positioned to meet an increase in loan demand, very few signals of any easing of terms or standards on business loans have been apparent to date.

In addition, other factors that hobbled the economy in the last several years are likely to persist in 1993, though perhaps with diminished intensity. Households and business are likely to remain cautious in using credit—a healthy development for sustained growth, but potentially continuing to constrain spending in the short run. Sizable imbalances in commercial real estate remain, and a significant rebound in this sector is doubtless several years off. Government spending at the federal, state, and local levels is likely to remain constrained. A number of foreign nations are confronting slow economic growth or recession, which is likely to hold back demand for our exports. And it is apparent from recent announcements by several large firms that corporate restructuring, involving significant cutbacks in operations and employment, is continuing.

Another very considerable uncertainty in the economic outlook is fiscal policy. The Congress and the Administration are considering both short-run fiscal stimulus and steps to reduce the deficit in the long run. Obviously, government spending and taxes could be affected by such measures in such a way as to influence directly the overall economy this year, although the bulk of any effect likely would occur in succeeding years. In addition, depending on the timing, dimensions, and credibility of any fiscal measures, market interest rates and stock prices could be affected appreciably, with implications for private expenditures.

While uncertainties thus remain, the economy appears to have entered the year with noticeable momentum to spending. In addition, inventories are at relatively low levels, and factory orders have been rising. Consumer confidence has recovered, and spending on durables and homes appears to be moving at a brisker pace. Recent surveys suggest an appreciable increase in business investment this year.

Against this background, members of the Board and Federal Reserve Bank presidents project a further gain in economic activity in 1993. The central tendency of our projections is for real GDP to increase at a 3 to 3½ percent rate this year. Such

an increase should result in a decline in unemployment, which would be expected to finish 1993 at 6¼ to 7 percent. Inflation is expected to remain low next year.

Containing, and over time eliminating, inflation is a key element in a strategy to foster maximum sustainable long-run growth of the economy. As I have often emphasized, monetary policy, by achieving and maintaining price stability, can foster a stable economic and financial environment that is conducive to private economic planning, savings, investment, and economic growth. It is no accident that the periods in our nation's history of low inflation were the times when the economy experienced high rates of private saving, investment, and hence productivity and economic growth. When inflation is low, endeavors to boost profit margins necessarily involve reductions in cost rather than increasing prices; thus, low rates of inflation tend to be associated with relatively high productivity growth. Conversely, periods of high and rising inflation here and abroad have been characterized by financial instability, an excessive amount of resources devoted to protecting financial wealth rather than production of goods and services, and substandard economic growth.

Over the past decade or so, our nation has made very substantial progress toward the achievement of price stability, reversing a dangerous upward trend of inflation and inflationary expectations. Last year's 3¼ percent increase in the core CPI was the lowest in twenty years and far lower than the debilitating double-digit rates at the close of the 1970s. As I have indicated to this Committee on numerous occasions, price stability does not require that measured inflation literally be zero, but rather is achieved when inflation is low enough that changes in the general price level are insignificant for economic and financial planning. At current inflation rates, we are thus quite close to attaining this goal.

The strategy of monetary policy will be to provide sufficient liquidity to support the economic expansion while containing inflationary pressures. The existing slack implies that the economy can grow more rapidly than potential GDP for a time, permitting further reductions in the unemployment rate.

Implementing this strategy, however, will be challenging. Judging the level of potential output and its rate of growth is difficult. Recent increases in productivity have been unusually strong, given the moderate pace of economic growth during much of the expansion, and it is unclear whether these rates of productivity gain can be continued. In addition, the monetary aggregates do not appear to be giving reliable indications of economic developments and price pressures and numerous other uncertainties cloud the particular features of the outlook. Monetary policy will have to adjust to unexpected developments as they occur, taking into account a variety of economic and financial indicators.

The contributions that monetary policy can make to maximum sustainable economic growth would be complemented by a fiscal policy focused on long-term deficit reduction. In the current environment, reducing the federal government's drain on scarce savings would take pressure off long-term interest rates, facilitating the readjustment of balance sheets and helping to promote capital formation and more robust economic growth over the longer term.

The Federal Reserve, in formulating monetary policy, certainly needs to take into account fiscal policy developments. Of course, it is not possible for the Federal Reserve to specify in advance what actions might be taken in the presence of particular fiscal policy strategies. Clearly, the course of interest rates and financial market conditions more generally will depend importantly on a host of forces—in addition to fiscal policy—affecting the economy and prices. And the effects of fiscal policy on the economy in turn will depend importantly on the credibility of long-run deficit reduction and the market reaction to any package. The lower long-term interest rates that resulted from a credible deficit-reduction plan would themselves have an immediate positive effect on the economy. In any event, I can assure you of our shared goal for the American economy—the greatest possible increase in living standards for our citizens over time.

The last several years have been difficult, and the economy is still adjusting to structural imbalances that have built up over recent decades. The near-term outlook, as always, is somewhat uncertain. But I believe that in many respects the inevitable painful adjustments have laid the foundation for better performance of our economy over the longer term. Financial positions have been strengthened; inflation is low and should remain subdued; labor productivity is increasing; resources are being shifted from national defense to investment and consumption. Nevertheless, the challenges ahead for policymakers will be considerable. While continuing to be supportive of the expansion of our economy over coming quarters, the monetary and fiscal authorities alike need to structure our policies to enable our economy to reach its full potential over time.

SUPPLEMENTAL STATEMENT OF ALAN GREENSPAN  
CHAIRMAN OF THE FEDERAL RESERVE BOARD

The President is to be commended for placing on the table for active debate the issue of our burgeoning structural budget deficit, which will increasingly threaten the stability of our economic system if we continue to fail to address it. Leaving aside the specific details, it is a serious proposal, its baseline economic assumptions are plausible, and it is a detailed program-by-program set of recommendations as distinct from general goals.

It is obviously very difficult to get a consensus on deficit cutting. If it were easy it would have been done long ago. The debate among the nation's elected representatives will be profoundly political, in the best sense of the word. As the nation's central bankers, our primary and professional concern is having the structural deficit sharply reduced and soon.

Time is no longer on our side. After declining through 1996, the current services deficit starts on an inexorable upward path again. The deficit and the mounting Federal debt as a percent of gross domestic product are corrosive forces slowly undermining the vitality of our free market system.

If we fail to resolve our structural deficit at this time, the next opportunity will doubtless confront us with still more difficult choices. How the deficit is reduced is very important, that it be done, is crucial.

In this regard, there are certain issues that I have discussed with this and other committees of the Congress over the years, which are worth repeating.

First, with current services outlays from 1997 and beyond rising faster than the tax base, stabilizing the deficit as a percent of nominal gross domestic product, not to mention a reduction, would require ever increasing tax rates. Hence, there is no alternative to achieving much slower growth of outlays. This implies not only the need to make cuts now, but to control future spending impulses. I trust the President's endeavor to reign in medical costs will contribute importantly to this goal.

Second, the hope that we can possibly inflate or grow our way out of the structural deficit is fanciful. Certainly greater inflation is not the answer; aside from its serious debilitating effects on our economic system, higher inflation, given the explicit and implicit indexing of receipts and expenditures, would not reduce the deficit. As I indicated in testimony last month to the Joint Economic Committee, there is a possibility that productivity growth may be moving into a faster long-term channel, boosting real growth over time. But even if that turns out to be the case, it wouldn't by itself resolve the basic long-term imbalance in our budgetary accounts.

Finally, fear that the deficit reduction can be overdone and create a degree of "fiscal drag" that would significantly harm the economy, I find misplaced. In our current political environment, to presume that the Congress and the President would jointly cut too much from the deficit too soon is in the words of my predecessor "nothing I would lose sleep over."

The Federal Reserve recognizes that it has an important role to play in this regard. In formulating monetary policy, we certainly need to take into account fiscal policy developments. But it is not possible for the Federal Reserve to specify in advance what actions might be taken in the presence of particular fiscal policy strategies. Clearly, the course of interest rates and financial market conditions more generally will depend importantly on a host of forces—in addition to fiscal policy—affecting the economy and prices. In any event, I can assure you of our shared goal for the American economy—the greatest possible increase in living standards for our citizens over time.

ADDITIONAL COMMENTS BY SENATOR CONNIE MACK

FEBRUARY 19, 1993

Mr. Chairman, I'd like to make some comments about several points that were raised in today's hearing.

Earlier in the discussion, the assertion was made that the economy is growing, but jobs are not. Because of this, we need fiscal "pump-priming" from the Federal Government.

There is absolutely no doubt that we would prefer to have jobs increase at a faster pace. We would always like to have more jobs rather than fewer jobs.

But do we need fiscal stimulus? The economy produced one and one-half million new jobs over the last year without any help from the Federal Government. What's more, if we are really interested in generating new jobs, the last thing we should be contemplating is a series of new taxes on capital and job-creators as the President is urging.

The second point that I want to address is an assertion made earlier about low wage jobs. This claim—that the jobs of the 1980's were low wage jobs—has been so discredited that it isn't even debated any more.

The Labor and Commerce Departments have produced volumes of data showing that most of the job growth of the last decade was in high wage occupations, not low wage ones. What seems like dozens of studies on this topic have crossed my desk, and I have yet to see a credible one that concludes otherwise.

The last comment I want to make is about the term "tax expenditures" someone used earlier. If there ever was an Orwellian term, it is tax expenditures.

My definition of a tax expenditure is tax revenue that doesn't exist. We all know that the Government gets revenue from taxing income. When the tax laws don't apply to some kinds of income, the Government doesn't get any revenue from that income. The missing revenue is called a tax expenditure. This seems pretty simple and straightforward, but it is a terrible concept. Here's why.

Most of us regard the income we earn to be, quite simply, our own. But using the term tax expenditures implies that "our" income belongs to the Government, not to us. The Government is assumed to have "spent" the money by letting us keep our own incomes.

Here's an example. Many of us own homes and have a mortgage. The income we use to pay the interest on that mortgage is not taxed.

Under the concept of tax expenditures, that mortgage-paying income was never really ours, it was the Government's. We are allowed to "keep" it in order to pay our mortgage. Government calls it a tax expenditure because it "spends" the money on us for the purpose of allowing us to pay that mortgage.

I think this is a ridiculous notion. Government does not have first claim on our income, we do. Government does not "spend" money by allowing us to keep our own income. I hope that we can rid the term "tax expenditures" from our vocabulary.

#### PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Mr. Chairman, I join you in welcoming Chairman Greenspan to discuss the the Federal Reserve Board's First Monetary Policy Report of 1993.

President Clinton told America that its time to face the facts. The fact is no program to revitalize the economy will work unless small businesses—the real engine of economic growth and employment—can get the credit necessary to buy equipment or inventory or to hire new workers.

Between 1980 and 1987, while the Fortune 500 companies eliminated 3.1 million jobs, small businesses created 17 million new jobs. Yet, as Chairman Greenspan acknowledges in his testimony small businesses are finding that they cannot get a bank loan.

While our small businesses are starved for credit, Alan Greenspan's testimony points out that there is no credit crunch for homebuyers. This is because we have a strong secondary market in securities backed by residential mortgages that facilitates the flow of credit from the capital markets to those who want to finance a home.

In 1984, Congress removed regulatory impediments to selling securities backed by pools of residential mortgages. We need to do the thing same for small business loans. That is why I introduced, and a majority of the members of the Banking Committee copponsored, the "The Small Business Loan Securitization and Secondary Market Enhancement Act."

This legislation removes unnecessary barriers in our securities, banking, pension and tax laws that deter the development of a secondary market in securities backed by small business loans. Once the legal barriers are removed, banks will be able to make small business loans, pool them, and sell securities backed by these loans to institutional and individual investors.

Removing unnecessary barriers to the development of a secondary market in small business loans will help bankers, small business borrowers and investors alike. Banks will be able to originate more small business loans without having to raise additional capital because the loans will be sold to investors rather than kept on the bank's book. Small businesses will gain access to the capital markets thereby making more credit available at lower prices. Institutional and individual investors will be able to fund small businesses by purchasing investment grade securities backed by small business loans.

Mr. Chairman, unlike many of President Clinton's proposals, fixing the credit crunch doesn't require higher taxes and more Government spending—it simply requires less Government red tape. It is time to get the credit flowing to fuel small business and boost the economy off the ground.

**ADDITIONAL QUESTIONS TO CHAIRMAN GREENSPAN**

**Q.1.** The FOMC's projection of economic growth this year is 3 to 3½ percent with 6¾ to 7 percent unemployment in the fourth quarter. If that projection turns out to be accurate, based on historical experience, how many new jobs would that be likely to produce this year?

**A.1.** Any estimate of the growth of jobs will necessarily be uncertain, owing to the problems of anticipating the composition of output gains and the changes in the work week and labor productivity. A rough assessment, based on historical productivity and other trends, would be that 3 to 3½ percent real GDP growth might be associated with an employment increase in the neighborhood of 2 million. The gain in 1992 fell well short of this, with productivity and work week increases accounting for larger shares of output growth than is typical. It remains to be seen whether 1993 conforms more to the historical average, or the relationships of 1992.

**Q.2.** With all the factors that threaten continued recovery—weak foreign economies, continuing high debt levels at households and businesses, low household saving rates, overbuilt commercial real estate markets, declining defense outlays, and budget problems of state and municipal governments—how confident are you that the economy won't start to slow down again later this year?

**A.2.** As I indicated in my testimony, while the economy seems to have developed a degree of forward momentum, factors such as those you mention do represent risks that we cannot afford to overlook.

**Q.3.** Because of the technical problems you describe, you've clearly paid little attention to M2 over the past year, which normally is the target for monetary policy. Given that M2 growth for 1993 is already well below even your new, lower range, and you've taken no action, it seems likely that you will pay little attention to M2 this year either. What exactly is the Fed targeting, and how do you set those targets?

**A.3.** In discussing the role of targets in monetary policy, distinguishing among operating targets, intermediate targets, and ultimate objectives is often useful. Operating targets refer to short-term objectives for reserve measures or the federal funds rate, which the Federal Reserve controls fairly closely. Intermediate targets can be set for certain economic or financial measures if it were judged that acting to attain such pre-established targets would tend to provide more assurance that ultimate objectives would be achieved over time. The Federal Reserve's ultimate long-term objectives are defined by the Humphrey-Hawkins Act to comprise maximum employment, stable prices, and moderate long-term interest rates. The Federal Reserve sees these goals as fully compatible over the long pull and, as explained in the recent Humphrey-Hawkins report and the accompanying testimony, monetary policy operations have been intended to promote these objectives.

A monetary aggregate was employed as a strict intermediate target between the fall of 1979 and the fall of 1982. During that period, the Federal Reserve's nonborrowed reserves operating instrument was set to foster attainment of a prespecified growth path for

M1. By the end of that period, however, the relationship between M1 and nominal income had become much less reliable, owing to regulatory changes, so the Federal Reserve began deemphasizing M1 and placing more emphasis on the broader aggregates, although they were treated more flexibly than had been the case earlier with M1.

Since 1982, the Federal Reserve has consistently set annual target ranges for the broader monetary aggregates and a monitoring range for domestic nonfinancial debt. The Federal Reserve has paid close attention to the behavior of the broader monetary aggregates in formulating operating policy, and at times has adjusted its operating targets in response to divergences of monetary aggregates from expectations. In addition, the Federal Reserve has cast its net widely in examining incoming economic and financial information for clues about evolving trends in economic activity, employment, and prices, and at times has changed its operating stances in response to such information as well. However, in light of the unusual and unpredictable distortions to the relationship between the broader monetary aggregates and nominal spending that have surfaced in recent years, and especially in 1992, the Federal Reserve has been forced to give less weight to the position of these aggregates relative to their annual ranges in policy formulation. At the same time, it has placed additional weight on other financial and economic reports in assessing the economic outlook and determining appropriate adjustments in our operating targets. It is fair to say that no single economic magnitude is currently used as a strict intermediate target in the sense that the operating target is systematically adjusted to foster attainment of the present intermediate target regardless of other economic and financial circumstances and trends.

**Q.4.** The OCC and the OTS charge the deposit institutions they supervise fees for their examinations. The President is proposing that the FDIC do likewise. Will the Fed join them, so that all depository institutions are treated alike?

**A.4.** Section 9, paragraph 8, of the Federal Reserve Act provides the Federal Reserve with explicit authority to decide whether to assess state member banks for examination expenses or to absorb these expenses. The Federal Reserve has a long-standing policy of not charging state member banks under its jurisdiction for examinations. The Board is reviewing this policy.

**Q.5.** The FOMC's projection for the CPI inflation rate shows further improvement this year to a range of 2½ to 2¾ percent. This year's core rate was already the lowest, absent price controls, in 26 years. How low is low enough? Are we there yet?

**A.5.** I've noted many times that we probably should think of the goal of price stability not so much in terms of a particular number as in the qualitative sense that inflation is sufficiently low that businessmen and households need not be concerned about general price level increases when they make their economic decisions. I do not think we are yet there, but we may not be very far from that point. As regards the qualitative issue, research suggests that quality changes and other measurement problems lead to some over-

statement of true inflation by the CPI, but likely not nearly so much as 2½ to 2¾ percent.

**Q.6.** Many analysts believe that Japanese authorities have allowed banks to be substantially underreserved given the increasing deterioration of their loan portfolios and have attempted to support stock market prices in Japan for the same reason. Are the Japanese, in your view, evading the Basle capital rules?

**A.6.** The Basle Accord provides a framework for setting minimum levels of capital that takes into account differences in risk profiles among internationally active banks. The Accord focuses principally on broad categories of credit risk; it does not explicitly cover factors other than credit risk, such as asset quality, which also bear on whether a bank's capital is adequate or realistically stated.

The Japanese financial sector has been under stress. It is clearly the responsibility of the Japanese authorities to undertake initiatives designed to manage and alleviate the systemic risks associated with the pressures in the Japanese stock and property markets.

The Japanese financial authorities have not backed away from their commitment to implement the final Basle rules which became effective for Japanese banks at the end of last month. They seem to appreciate the long term value of a financial system based more fully on market incentives.

The reserving practices that have historically kept Japanese banks' loan loss reserves at low levels have not changed substantially. As in other countries, reserving is affected importantly by tax considerations. In Japan, reserves typically reflect permission by the authorities to allow tax-deductible reserves against loans that have already gone bad. The reluctance of the tax authorities to grant such permission leads to lower reserves than otherwise would prevail. However, attitudes in Japan do appear to be changing. Governor Mieno recently stated, "It is becoming more and more important for financial institutions . . . to write off and establish reserves for nonperforming assets as appropriate to the actual situation."

Moreover, in complying with the Basle capital rules, Japanese banks have had to make costly adjustments to their weakened financial situations, including raising large amounts of costly subordinated debt and reducing the size of their balance sheets. Though pressure on the capital positions of banks is reduced by the positive effect on the stock market of the Japanese government's stimulative measures, this seems to be a side effect of policies whose primary goal is to ensure financial and economic stability.

Based on the above, we do not think the Japanese have evaded the Basle capital rules.

**Q.7.** Do you and the other bank regulators have contingency plans for handling the failure of a major U.S. bank, if such an unfortunate event were to occur?

**A.7.** The failure of one of the nation's significant banking institutions would undoubtedly present the agencies with a major challenge, and that challenge would obviously be compounded if more than one such institution was in critical conditions at the same

time. Certain provisions of FDICIA, such as requirements for annual examinations, strong capital levels, and prompt corrective action, will help to complement and strengthen the policies and procedures already in place to minimize the possibility of such situations. Other elements, however, may complicate resolving problems that arise by placing uninsured depositors and creditors at greater risk and, thereby, increasing the possibility of bank "runs." It is thus clear that the agencies supervising our major institutions will need to move very quickly and effectively to address major problem situations.

I believe that the agencies are prepared to carry-out that responsibility. The Federal Reserve has arrangements in place that enable us to assemble examiners from all of our Reserve Banks to assist in dealing with a large problem institution. Such arrangements were utilized, for example, in the thrift problems in Ohio and Maryland and in the troubled banking situations of Texas and New England. The other agencies have similar capabilities and policies in place. It will also be necessary for the agencies to work cooperatively in addressing major problems, and I believe that past experience demonstrates their ability and commitment to do so.

**Q.8.** Last fall, legislation was enacted that gave the Fed unified control over margins for stocks, stock futures, and stock options. The intent, in response to the stock market crash of 1987 and the mini-crash of 1989, was to enable the Fed to examine the adequacy and consistency of margins across these markets and make any necessary changes. Have you begun such an examination, and when will we know the results?

**A.8.** The legislation enacted last fall gave the Board authority over rules of futures contract markets establishing or changing levels of initial and maintenance margins on stock index futures contracts and options on such contracts. Specifically, the Board was given the authority to request and direct contract markets to alter or supplement rules setting levels of margins on such contracts in order to ensure that they are appropriate "to preserve the financial integrity of the contract market or its clearing system or to prevent systemic risk." Furthermore, the legislation permitted the Board to delegate this authority to the Commodity Futures Trading Commission, subject to whatever conditions the Board deems appropriate.

The Board has reviewed the procedures used by U.S. exchanges to set margin levels for stock index futures and futures options. The Board has concluded that these procedures can be evaluated meaningfully only, in the context of the overall risk management systems that these contract markets have in place to preserve their financial integrity and, thereby, to prevent systemic risk. As indicated in the attached letter, because the CFTC is most familiar with the overall risk management systems involved, the Board has delegated the futures margin authority to the Commission. As indicated in the letter, the Board expects the Commission to pay particular attention to the procedures for determining margin levels on portfolios that include futures options and to the ability of the contract market to cover any losses and meet its financial obligations in a timely manner in the event of a default by a large participant.

The Board expects the Commission to report annually on its experience reviewing rules pertaining to margin levels.

**Q.9.** The Clinton Administration has shown interest in revitalizing the G7 process to try and get the economic strategies of the major industrialized countries more compatible. We are now moving toward a significant deficit reduction, something other countries have been encouraging for years. What should we be asking of them, in order, for example, to help get our current account deficit down?

**A.9.** The primary objective of the G7 process has been and should continue to be to cooperate with other countries to produce a healthy and expanding world economy. Because economic conditions differ across countries at any given point in time, policy strategies that are consistent with achieving this objective are not necessarily the same for all countries. Moreover, achievement of balanced current accounts, and in particular, reduction of the U.S. current account deficit, is not the principal objective of the G7 process, though imbalances that threaten overall financial stability may be symptomatic of unhealthy divergences in economic policies. Nevertheless, policies in Europe and Japan that are directed at the resumption of non-inflationary growth and the return of production to rates in line with their economic potential are in their interests as well as our own. The pursuit of such policies should also help to narrow our external deficit.

For use at 9:45 a.m., E.S.T.  
 Friday  
 February 19, 1993

Board of Governors of the Federal Reserve System




---

Monetary Policy Report to the Congress  
 Pursuant to the  
 Full Employment and Balanced Growth Act of 1978

---

February 19, 1993

---

Letter of Transmittal

---

BOARD OF GOVERNORS OF THE  
 FEDERAL RESERVE SYSTEM  
 Washington, D.C., February 19, 1993

THE PRESIDENT OF THE SENATE  
 THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress, pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,

A handwritten signature in black ink, appearing to read "Alan Greenspan".

Alan Greenspan, Chairman

---

**Table of Contents**

	<i>Page</i>
<b>Section 1:</b> Monetary Policy and the Economic Outlook for 1993	1
<b>Section 2:</b> The Performance of the Economy in 1992	6
<b>Section 3:</b> Monetary and Financial Developments in 1992	19

## Section 1: Monetary Policy and the Economic Outlook for 1993

Last July, when the Federal Reserve Board presented its semiannual monetary policy report to the Congress, there was considerable uncertainty about the prospects for the economy in the second half of 1992. After a promising start at the beginning of the year, growth of the economy had slowed once again in the spring, and various structural adjustments that had been impeding the pace of the expansion retained considerable force. However, with drag from the structural adjustments expected to diminish gradually over time and with the economy continuing to benefit from the substantial easing of money market conditions that the System had implemented over the years, the most likely prospect for the economy was thought to be one of moderate growth in the second half of the year.

In the event, economic growth did indeed proceed at an improved pace in the second half of 1992, although the pickup did not start to become evident in the incoming economic data until well into the autumn. Fueled by strong increases in household and business spending, real gross domestic product rose at an annual rate of 3.6 percent in the second half of the year. The increase over the four quarters of the year amounted to 2.9 percent. This was the largest gain in output since 1988, and, while far from robust by the standards of past cyclical upswings in activity, it was a much stronger performance than many analysts—inside and outside of government—had thought likely, given the extraordinary headwinds with which the economy had to contend. Indeed, the performance of the U.S. economy stands in sharp contrast to that of a number of major foreign industrial economies that appear still to be laboring to regain forward momentum.

Employment has grown since the middle of last year, but at only a gradual pace. Hiring has been damped by the ability of firms to meet their output objectives through hefty increases in productivity. The unemployment rate, which had risen in the first half of 1992 in conjunction with a surge in the share of the working-age population in the labor force, turned down thereafter as labor force participation fell back. The unemployment rate in January of this year was 7.1 percent, more than half a percentage point below the peak rate of last summer.

Price developments remained favorable in the second half of 1992, and the rise in the consumer price index over the four quarters of the year amounted to

3 percent, matching the low rate achieved in the previous year. Consumer energy prices turned back up in 1992, but the prices of other goods and services that enter into the CPI generally rose less rapidly than they had in 1991. Although the CPI spurted  $\frac{1}{2}$  percent this past month, the underlying trends in labor costs and prices remain encouraging. The success to date in keeping inflation in check, while restoring growth, has had highly salutary effects on financial markets and on the process of financial reconstruction, the continuing progress of which is essential to the achievement of renewed and sustainable prosperity.

The hesitant pace of the economy evident in incoming information throughout much of last year, along with notable weakness in the monetary and credit aggregates and steady gains against inflation, prompted the Federal Reserve to ease monetary conditions three times, bringing short-term rates down by another full percentage point over the year. The discount rate was reduced to three percent and short-term rates generally are now at their lowest levels since the early 1960s.

Long-term rates also fell, on balance. Declines were limited at times, however, by concerns about prospective federal budget deficits and about the possibility that inflation might begin to move higher as the expansion proceeded. Notable decreases in long rates were registered in late 1992 and early 1993, as inflation remained subdued and as statements by Administration officials suggested that they would seek only limited near-term fiscal stimulus and that proposals to make substantial cuts in the federal budget deficit over time were under serious consideration. The trade-weighted foreign exchange value of the dollar in terms of the other Group-of-Ten currencies appreciated on balance over the course of 1992 and rose further during the first weeks of 1993. The dollar benefited from the improved performance of the U.S. economy relative to conditions in other industrial countries.

Growth of the monetary aggregates slowed last year despite an acceleration in nominal spending and income. For the year, M2 advanced 1.9 percent, below the  $2\frac{1}{2}$  percent lower end of its target range. M3 also came in under its 1 to 5 percent target range, growing only .5 percent. The Federal Reserve did not make greater efforts to boost growth to within these ranges

because, as the year went on, it became increasingly clear that slow growth of the broad money aggregates did not indicate that financial market conditions were impeding the expansion of spending and income. In fact, growth of nominal GDP exceeded that of M2 by 3½ percentage points last year and that of M3 by 4¼ percentage points. Not only did data on spending itself show a firming trend over the year, but narrow money (M1) and reserves were expanding rapidly—suggesting to some that liquidity was quite ample—and the growth of debt, while restrained, was considerably in excess of that of the broader monetary aggregates.

Nominal GDP growth last year, which picked up to 5.4 percent from 3.5 percent in 1991, was fueled by spending that was financed largely outside of banks and other depositories, whose liabilities constitute the lion's share of the monetary aggregates. Spurred in part by advances in equity prices and by declines in longer-term interest rates, businesses and households strengthened their balance sheets by raising funds in bond, mortgage, and equity markets, and repaying bank loans and other short-term debt. This shift in the focus of financing efforts toward the capital markets, a process which has been in progress for the last couple of years, has helped to redress financial distortions that accompanied the buildup of debt and the rapid rise in some asset prices in the 1980s.

The low level of credit demanded from depositories has meant that these institutions have not needed to seek large volumes of deposits. As a consequence, rates paid on deposits have been adjusted downward rapidly as short-term market rates have declined. Savers, reacting to the lower deposit rates and to attractive returns on bonds and equity, have shifted funds from M2 deposits into the capital markets. One method savers have used to capture these higher capital market yields has been through purchases of bond and stock mutual funds, which are not included in the monetary aggregates, and which together experienced record inflows in 1992. Moreover, consumer loan rates have fallen by less than deposit rates, and households appear to be using M2 assets to repay consumer debt or restrain its growth. The combination of rate incentives, desires to strengthen balance sheets, and the greater availability at low transaction cost of a broadened array of savings vehicles beyond traditional deposits appear to have distorted, at least for a time, the traditional relationship between levels of M2 and M3 assets and given levels of spending.

Although growth of M2 and M3 was very weak last year, M1 accelerated to 14.3 percent, the second fast-

est annual increase recorded in the official series, which begins in 1959. In part, this pickup owed to the expansion of spending, but it mainly reflected the tendency for rates on liquid deposits to adjust downward less rapidly than those on time deposits. In response, savers shifted substantial volumes of funds from maturing time deposits to NOW accounts. In addition, businesses boosted their demand deposits substantially. To support this growth in transactions deposits, the Federal Reserve added substantial volumes of reserves in 1992. Total reserves increased 20 percent last year, and the monetary base, which includes currency outstanding as well as reserves, increased 10.5 percent, the highest rate ever registered in the official series.

Decisions to strengthen balance sheets had a smaller but significant effect on debt growth. The debt of nonfinancial sectors is estimated to have expanded 4.6 percent, only slightly faster than in 1991 and just above the lower end of its monitoring range. With debt growing less rapidly than income and with declines in market interest rates allowing higher cost debt to be rolled over at lower rates, households and businesses made substantial further progress in reducing debt service burdens.

### Monetary Objectives for 1993

The aim of the Federal Open Market Committee in 1993 is to promote financial conditions that will help to maintain the greater momentum that the economy developed in 1992 and to consolidate the trend toward lower inflation. The objectives for the monetary aggregates in 1993 were set with that aim in mind.

At its July 1992 meeting, the Committee had provisionally chosen the same ranges for 1993 as it was confirming for 1992—2½ to 6½ percent for M2 and 1 to 5 percent for M3, with a monitoring range for the nonfinancial debt aggregate of 4½ to 8½ percent. At that time, the Committee noted that the extent and duration of deviations of money growth from historical relationships remained highly uncertain and that the actual setting, in February, of 1993 ranges consistent with the basic policy objectives would need to be made in light of additional experience and analysis.

At its February meeting, in reviewing the ranges provisionally chosen for 1993, the Committee noted that nominal spending had accelerated considerably in 1992 despite the quite sluggish growth of M2 and M3 throughout the year. The Committee viewed this development as underscoring the importance that

### Ranges for Growth of Monetary and Credit Aggregates

	1991	1992	1993
<i>Percentage change, fourth quarter to fourth quarter</i>			
<b>M2</b>	2½ to 6½	2½ to 6½	2 to 6
<b>M3</b>	1 to 5	1 to 5	½ to 4½
<b>Debt</b>	4½ to 8½	4½ to 8½	4½ to 8½

special, and historically anomalous, forces have had in restraining the growth of broad money relative to spending. While the intensity of some of these forces might diminish in 1993, as borrowers and lenders achieve more comfortable balance sheet positions, they are unlikely to end. For example, the substantial volume of liquid securities on banks' balance sheets suggested that they will not become vigorous bidders for deposits in 1993 even if, as expected, lending picks up. In addition, the yield curve, although it had begun to flatten a bit early in the new year, is likely to continue to provide savers an incentive to shift funds out of monetary assets and into capital markets—a process facilitated by the growing availability of mutual funds at banks and thrifts.

Given that these forces, and others, tending to channel funds around depository institutions and hence to raise velocity—the ratio of nominal GDP to money—seem likely to persist in 1993, a downward adjustment to the money ranges is appropriate to take account of the expected atypical behavior of velocity: Lower money growth than normally expected would be sufficient to support substantial growth in income. With this in mind, the Committee made a technical downward adjustment in the target growth ranges for M2 and M3, reducing the upper and lower ends of each range by ½ percentage point.

The strength of the influences depressing money growth relative to income remains somewhat uncertain, however. If they persist in 1993 to the same extent as in 1992, growth of M2 and M3 in the lower portions of their reduced target ranges would be consistent with substantial further growth of nominal spending. Alternatively, the upper ends of the target ranges would accommodate ample provision of liquidity to support further economic expansion even if the growth of money and income were to begin coming into more normal alignment, and the recent

high rate of increase in velocity were to slow. The Committee will continue to examine money growth as the year unfolds for evidence on developing economic and financial conditions. As in the past, the Federal Reserve will be guided also by a careful assessment of a wide variety of other financial and economic indicators. The Committee's primary concern, as in 1992, will remain that of fostering financial conditions conducive to sustained economic expansion and a noninflationary environment.

For debt growth, which has been less damped by special forces than has the expansion of the broader monetary aggregates, last year's range was retained for 1993. Federal debt growth again is likely to be substantial. Growth of the debt of nonfederal sectors is expected to accelerate somewhat as borrowers' balance sheets continue to improve, as intermediaries become more willing to lend, and as the economy expands. Nevertheless, the growth of nonfederal debt is expected to remain below that of nominal GDP, a development the Committee sees as contributing to building the sound financial foundation crucial to a sustained economic expansion.

#### Economic Projections for 1993

Although the economy and the financial markets continue to face difficult adjustments, the governors and Bank presidents think that the most likely prospect for 1993 is that economic growth will proceed at a moderate pace. The growth of output probably will be supported by further gains in productivity, the ultimate source of increased real income and improved living standards over the long run. In addition, increases in employment are expected to be large enough to bring further gradual declines in the unemployment rate over the course of 1993. Inflation is expected to remain subdued, boding well for sustained expansion in 1993 and beyond.

## Economic Projections for 1993

Measure	Memo: 1992 Actual	FOMC Members and Other FRB Presidents	
		Range	Central Tendency
<i>Percentage change, fourth quarter to fourth quarter</i>			
<b>Nominal GDP</b>	5.4	5¼ to 6¼	5½ to 6
<b>Real GDP</b>	2.9	2½ to 4	3 to 3¼
<b>Consumer price index<sup>1</sup></b>	3.1	2½ to 3	2½ to 2¾
<i>Average level in the fourth quarter, percent<sup>2</sup></i>			
<b>Unemployment rate</b>	7.3	6½ to 7	6¾ to 7

1. CPI for all urban consumers.

2. Percentage of the civilian labor force.

The governors' and Bank presidents' forecasts of real GDP growth over the four quarters of 1993 span a range of 2½ percent to 4 percent, with the central tendency of the forecasts in a range of 3 to 3¼ percent. In considering the possible outcomes for 1993, the governors and Bank presidents cited the degree of momentum that appears to have developed in the economy in the latter part of 1992 and early 1993. The various balance sheet problems that apparently retarded growth of the economy during the early phases of the current expansion, while by no means fully resolved, seem to be receding. In addition, sectors such as residential construction, business investment, and consumer durables clearly are benefiting from the declines that have occurred in interest rates.

However, impediments to more rapid expansion still are present. Government spending for defense appears likely to continue to decline for some time to come. More broadly, balance sheet repair and business restructuring, which have exerted major restraint on economic activity in recent years, still are in process, despite the apparent improvement in business finances in 1992. Indeed, the new year has brought additional announcements of business restructurings in a variety of industries, both defense-related and other. These changes are leading to an economy that is more productive and competitive, but at the cost of some dislocation and disruption in the short run. The magnitude of structural changes like these is a special uncertainty in the economic outlook for the remainder of the year. With regard to the external sector, many foreign industrial countries are experi-

encing prolonged economic weakness. Under the circumstances, the growth of U.S. exports, while remaining positive, may well fall short of the growth of imports again in 1993, exerting a drag on real GDP in contrast with the substantial impetus in the period up to early 1991.

Despite the job cutbacks at some large companies, other firms, especially smaller ones, are adding to payrolls, albeit cautiously, and total employment has been rising modestly. The governors and Bank presidents expect this pattern to persist, with net gains in employment during 1993 likely to be sufficient to bring the unemployment rate down somewhat further over the course of the year. The central tendency of the unemployment rate forecasts for the fourth quarter of 1993 extends from 6¾ percent to 7 percent; the remaining forecasts of the System officials range down to about 6½ percent.

The governors' and Bank presidents' forecasts of the rise in the consumer price index over the four quarters of 1993 extend from a low of 2½ percent to a high of 3 percent. Within that range, a large majority of the forecasts are clustered in the span of 2½ to 2¾ percent. The considerable progress that has been made in bringing down inflation during the past decade is providing one of the essential underpinnings for the sustained growth of real living standards over the long run.

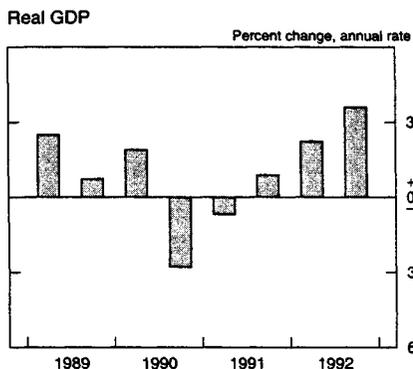
However, achieving a satisfactory economic performance in 1993—and in the years thereafter—will depend on initiatives in many types of policy other

than monetary policy. In coming months, Congress and the new Administration will be grappling with a host of issues, including those related to fiscal policy, regulatory policy and foreign trade policy. Far-sighted approaches are needed in all those areas, if the economy is to perform at its full potential over the long haul. In framing regulatory policy and foreign trade policy, Congress and the Administration will need to keep an eye on potential costs and rigidities that could

sap the vigor of a market economy. With regard to fiscal policy, credible action to reduce the prospective size of future federal budget deficits could yield a very direct and meaningful payoff in the form of lower long-term interest rates than otherwise would prevail. Such action would encourage capital investment and would go far toward relieving anxieties that many of the nation's citizens still have about longer-run economic prospects.

## Section 2: The Performance of the Economy in 1992

The economy began to exhibit renewed firmness in 1992, overcoming a host of impediments that have been working to retard the growth of activity. With the strengthening of growth in the second half, to a 3.6 percent rate, the rise in real GDP over the year cumulated to 2.9 percent, the strongest gain since 1988. Employment also picked up in 1992, but rather slowly; the unemployment rate continued to move up in the first half of the year, but thereafter followed a course of gradual decline. Inflation continued to trend lower in 1992, with most broad price indexes showing increases that were among the smallest since the mid-1960s.



The growth of household and business expenditures picked up appreciably in 1992. Households, for their part, began to spend more freely on motor vehicles and other goods, and their purchases of homes also strengthened, spurring additional gains in residential construction. Businesses began investing more heavily in new equipment; much of that gain went for computers and other electronic equipment embodying new technologies. Business outlays for nonresidential construction declined, on net, over the year, but by a much smaller amount than in 1991. In total, the final purchases of households and businesses rose about 4¼ percent in real terms in 1992, after declining in each of the two previous years; the 1992 gain matched that of 1988 and otherwise was the largest in eight years. By contrast, governments at all levels continued to be burdened by huge budget deficits in 1992, and, for a second year, their combined purchases of

goods and services changed little in real terms. In addition, export growth was slowed by weakness of activity in several foreign industrial economies; despite improvement in the second half, the rise in real exports of goods and services over the year, 3½ percent, was only about half as large as the annual gains in 1990 and 1991. Meanwhile, the faster growth of domestic spending pushed up the growth in imports of goods and services to 9¼ percent in 1992.

Further progress was made in reducing inflation last year. The consumer price index excluding food and energy—a measure widely used in gauging the underlying trend of inflation—increased about 3½ percent over the four quarters of 1992; this was a full percentage point less than the increase during 1991. The total CPI rose about 3 percent over the four quarters of 1992, the same as in the previous year; energy prices, which had fallen sharply in 1991, turned up slightly this past year, while increases in food prices were quite small for the second year in a row. Except for 1986, when the CPI was pulled down by a collapse of world oil prices, the increases of the past two years are the smallest in a quarter century.

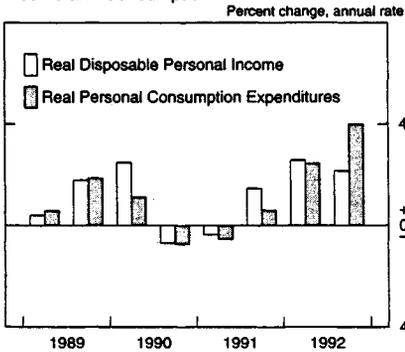
### The Household Sector

The financial condition of households improved in 1992. Income growth picked up a little in the aggregate, the strains on household balance sheets eased a bit, and the spirits of consumers brightened markedly toward year-end. Growth in consumer spending followed a stop-and-go pattern through midsummer, but the gains thereafter were steadier and fairly sizable overall. Spending for residential investment also advanced over the year, by a considerable amount in total.

The aggregate wealth of households appears to have increased further during 1992. With stock prices increasing, the value of households' financial assets rose moderately, and the value of residential real estate also moved up, on average. On the liability side, households remained cautious in taking on new debt in 1992, and the burden of carrying debt continued to ease, owing both to slow growth in the volume of debt outstanding and to the further reductions in interest rates, which facilitated the ongoing substitution of new, lower-cost debt for old, higher-cost obligations. The incidence of households experiencing loan repayment difficulties diminished over the year.

Income growth picked up moderately in 1992. Wages and salaries rose about 4¼ percent in nominal terms, after a gain of only 2¼ percent in 1991. In addition, proprietors' incomes benefited from the strengthening of economic activity, and, with corporate profits on the rise, the dividends paid to shareholders more than reversed their decline of the previous year. Transfer payments, which had soared as the economy softened in 1990 and 1991, continued to grow rapidly in 1992. By contrast, interest income trended sharply lower, as the rates of return on household deposits and other financial assets fell further. Total after-tax income got a temporary boost in 1992 from an adjustment of federal tax withholdings that took effect at the start of March. With inflation low, real disposable personal income increased nearly 2½ percent over the year—not a large gain by past cyclical standards, but nonetheless the biggest since 1988.

#### Income and Consumption



Real personal consumption expenditures rose about 3¼ percent over the four quarters of 1992, after essentially no gain over the two previous years. For a considerable part of 1992, the increases in spending were interspersed with stretches of sluggishness. A surge in consumer expenditures early in the year was followed by listlessness during the spring, and a second jump in spending around mid-year was followed by still another bout of slow growth during the summer. However, the last few months of the year brought fairly sizable advances, boosting the growth of consumption expenditures to a rate of more than 4 percent in the fourth quarter.

Consumer expenditures for motor vehicles increased about 9 percent over the four quarters of 1992. More than half of that gain came in the fourth

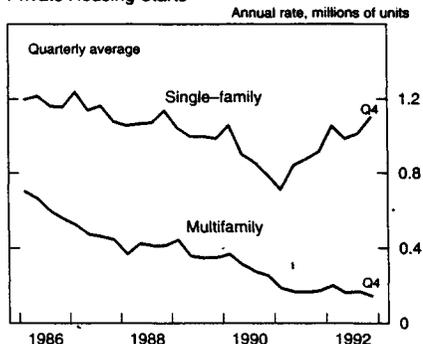
quarter, when sales of new vehicles were boosted by special promotional incentives and, apparently, by a growing perception among consumers that better economic conditions lay ahead. At the start of 1993, after some of the more highly-publicized promotional programs had ended, sales of cars and light trucks fell sharply for a brief time, but they since appear to have regained strength. More than likely, some fundamental support for sales is coming from the replacement needs of persons who had put off buying new vehicles during the recession and the early phases of the recovery.

Spending picked up during the second half of 1992 for many items other than motor vehicles, with notable gains in categories in which an element of discretion typically enters into households' purchasing decisions. Real outlays for furniture and household equipment rose at an annual rate of nearly 15 percent in the second half of 1992, and real expenditures for apparel climbed at nearly a 10 percent rate. In total, spending for consumer durables other than motor vehicles grew about 9 percent in real terms over the four quarters of 1992, after declining in each of the two previous years. Real outlays for nondurables, which also had fallen in both 1990 and 1991, rose almost 3 percent in the latest year. Real expenditures for services increased about 2 percent during 1992, slightly faster than in other recent years.

The personal saving rate—the share of disposable income not used for consumption or other outlays—rose moderately in the first half of the year, when concerns of households about the prospects for the economy apparently led them to adopt more cautious attitudes toward spending. The rate then turned down in the second half of the year, as consumers began to spend more freely. The fourth-quarter rate was slightly below the average for 1992, but it was well within the range of quarterly observations seen over the past several years.

Real outlays for residential investment rose 15 percent during 1992, climbing to a fourth-quarter level nearly 25 percent above their recession low of early 1991. Most of the 1992 rise in residential investment came in the form of increased construction of single-family housing units, which benefited from the further net reduction in mortgage interest rates over the course of the year. Outlays for home improvements, which make up about one-fifth of total residential investment, also increased in 1992, after declining in each of the three previous years; repair of the damage caused by Hurricane Andrew accounted for part of that gain. By contrast, multifamily housing remained depressed; high vacancy rates and unfavorable demo-

## Private Housing Starts



graphic trends continued to be big obstacles to new construction activity in that portion of the market.

As with consumer spending, the gains in single-family housing activity tended to come in intermittent bursts through much of 1992. Sales of new homes surged early in the year, weakened in the spring, surged again during the summer, and then fell back just a touch in the fourth quarter; on net, the increase over the year amounted to 12 percent. Mortgage interest rates, while lower than in 1991, exhibited some mild swings during 1992, and these swings appear to have contributed to the fluctuations in home sales. In addition, proposals early in the year for a tax credit for first-time homebuyers may have affected the timing of purchases to some degree.

Construction activity in the single-family sector also had its ups and downs in 1992, influenced by unusual weather patterns as well as by the fluctuations in sales. Nonetheless, the trend over the year as a whole was decidedly upward, and the average level of starts in the fourth quarter was about 20 percent above that of a year earlier. In January, single-family starts fell back somewhat; volatility in the monthly data on starts is not unusual at this time of year, however.

Despite the large gains seen in 1992, starts in the single-family sector have retraced only part of the decline that took place in the late 1980s and early 1990s. Strong impetus for recovery has come from declines in mortgage interest rates, which have been considerably lower this past year than they were in 1986, when single-family starts were at their most recent annual peak. However, a number of other developments have continued to retard the recovery of housing activity. Uncertainties about job prospects

no doubt have deterred some buyers from taking advantage of the lower rates on home mortgages. More broadly, recent demographic trends have been less favorable to growth in the demand for single-family housing than were the trends of the mid-1980s. The declines in house prices that have occurred in a number of regions in recent years—and the more general lack of any real price appreciation to speak of—also may have affected demand to some extent; certainly, housing is no longer viewed by potential buyers as the sure-fire, high-yield investment that it was once thought to be.

Builders, for their part, have remained a little cautious, as have the lenders who finance new construction. In many cases, houses are being started only when a buyer actually is lined up; eagerness to build in anticipation of future sales is not widely apparent.

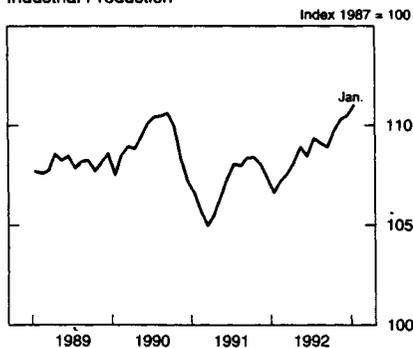
In the multifamily sector, the number of units started in 1992 was about 75 percent below the peak rates of the mid-1980s; the sector accounted for only 6 percent of total residential investment this past year. The overbuilding that occurred in the multifamily sector in the mid-1980s led to high vacancy rates that have stymied activity ever since. In that regard, little progress was made in reducing vacancy rates for multifamily rental units in 1992, despite the greatly diminished level of new construction. The speed at which the excess supply of space can be worked off is being limited by declines in the population of young adults, as well as by the slow rate of depreciation of these long-lived structures.

### The Business Sector

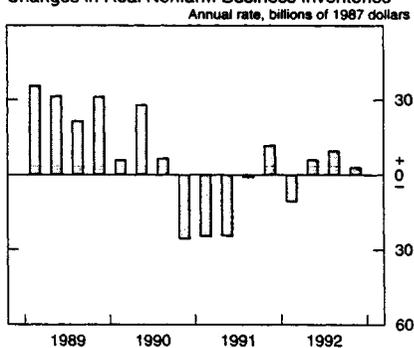
The past year brought moderate increases in activity in the business sector of the economy. Production, sales, and orders rose, on net, over the year, and business profits continued to swing back up from the recession lows of 1991. Many businesses continued to undertake major structural changes designed to cut costs and enhance efficiency. Those changes were manifest both through reorganization of existing operations and through investment in new technologies. Businesses also continued to shore up their finances, trimming away debt and building equity. Financial pressures persisted in the business sector in 1992, but, in general, they seemed to become less acute as the year progressed.

Industrial output rose nearly 3 percent from December of 1991 to December of 1992. Production fell in the first month of 1992, but then picked up, rising about ½ percent per month from February through

Industrial Production



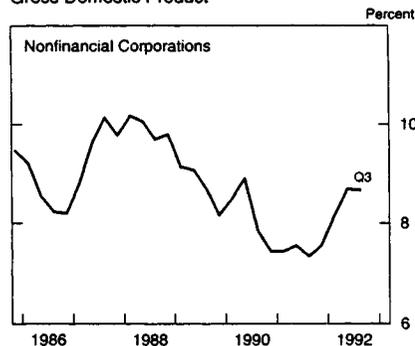
Changes in Real Nonfarm Business Inventories



May. During the summer, the expansion of activity seemed to be losing momentum; orders and shipments fell slightly, on net, from May to August, factory inventories backed up a little, and industrial production essentially flattened out over a four-month stretch. However, orders and shipments began moving up once again in September, and they increased considerably in the fourth quarter. Industrial production also picked up once again in the fourth quarter, and a further gain, amounting to 0.4 percent, was recorded in January of this year.

Business profits, which had taken a turn for the better late in 1991, improved further during 1992. The operating profits earned by nonfinancial corporations from their domestic operations rose 18 percent from the final quarter of 1991 to the third quarter of 1992.

Before-tax Profit Share of Gross Domestic Product\*



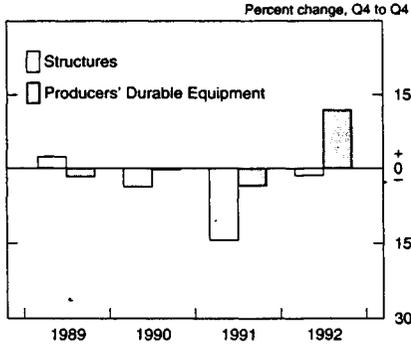
\*Profits from domestic operations with inventory valuation and capital consumption adjustments divided by gross domestic product of nonfinancial corporate sector.

and a further gain seems implicit in the available data for the fourth quarter. (An actual estimate of fourth-quarter profits will not be published by the Commerce Department until late March.) Profits of these firms have been lifted, in part, by increases in the volume of output since the end of the recession. In addition, tight control over costs has led to increases in profits per unit of output. Unit labor costs of nonfinancial corporations have risen only slightly since the start of the current economic expansion, and their net interest costs have declined sharply, owing to lower interest rates and restraint in the use of debt. The domestic profits of financial corporations were strong in the first half of 1992, but were severely depressed in the third quarter by the unprecedented losses that insurance companies suffered in the wake of Hurricane Andrew; in the absence of the hurricane, profits in the financial sector would have increased in the third quarter.

The economic condition of smaller companies also seemed to improve somewhat in 1992. The past year's estimated rise in the profits of nonfarm proprietors was the largest annual gain since the mid-1980s; increases had been relatively small over the three previous years.

The net income of farm proprietors turned back up in 1992, after a moderate decline in 1991. Farm output rose to a record high in 1992, with strong gains for both crops and livestock. Prices, meanwhile, lagged year-earlier levels through much of 1992, but most of that slippage in farm prices already had taken place by the start of the year; the average level of farm prices in December of 1992 actually was about the same as that of a year earlier. Farm production expenses edged down for a second year, as farm

## Real Business Fixed Investment



operators, like their nonfarm counterparts, continued to maintain tight control over costs.

Business investment in fixed capital rose about 8 percent in real terms during 1992, more than reversing the decline of the previous year. Spending for equipment increased in each quarter of 1992, and the gains cumulated to nearly 12 percent by the fourth quarter; with spare capacity still extensive in most industries in 1992, much of the gain in equipment spending over the year probably was a result of the desire of businesses to modernize their operations. Meanwhile, nonresidential construction spending, which had plunged 14 percent in 1991, fell by a much smaller amount in 1992—1½ percent according to the estimate in the most recent GDP report.

Spending for computers was at the forefront of the rise in equipment outlays in 1992. In terms of annual averages, the nominal outlays for office and computing equipment rose about 17 percent; the gains in real terms were much greater still, as technological advances and competitive market conditions combined to continue driving down the price of real, effective computing power. Businesses also boosted their outlays for telecommunications equipment, especially in the second half of 1992. Spending for motor vehicles strengthened in 1992, and investment in industrial equipment edged up after three years of decline. Spending for aircraft traced out a volatile pattern during 1992 and, for the year as a whole, was down only moderately from the high level of 1991; however, these outlays closed the year on a weak note, and prospects for 1993 are not encouraging, given the losses that have been experienced by airline companies and the related cancellations and stretch-outs of orders.

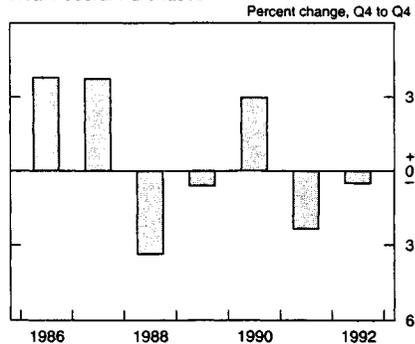
The small decline in nonresidential construction outlays during 1992 reflected some widely divergent trends across the various types of construction activity. Spending for new office buildings fell sharply further during the year, to a fourth-quarter level that was about 60 percent below the peak of the mid-1980s. In addition, the real outlays for industrial structures declined in 1992 for the second year in a row, influenced, no doubt, by the current high levels of unused industrial capacity and by the ongoing trend toward tighter control of inventories and concomitant reductions in needed storage space. Annual outlays for oil and gas drilling also fell further in 1992; a rise in drilling in the year's final quarter probably was prompted mainly by a year-end phase-out of certain tax incentives, although some drillers may also have been responding to an upturn in natural gas prices over the year.

Other types of construction activity fared better in 1992. Spending for commercial structures other than office buildings moved up over the year, after sharp declines in both 1990 and 1991, and the outlays of utilities rose appreciably, boosted by environmental requirements as well as by further moderate additions to capacity. Increases in construction spending also were reported for various types of institutional structures, such as religious facilities and hospitals.

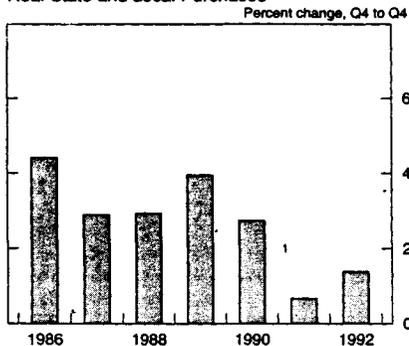
## The Government Sector

Government purchases of goods and services, the portion of government spending that is included in GDP, increased slightly in real terms over the course of 1992, after declining slightly during 1991. Federal purchases fell ½ percent in real terms over the

## Real Federal Purchases



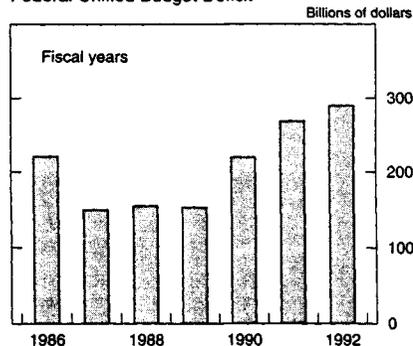
## Real State and Local Purchases



year, as a further decline in real defense purchases more than offset another year of increase in real non-defense purchases. State and local purchases of goods and services increased about 1½ percent during 1992, a slightly larger rise than in 1991, but still well below the rates of increase seen through much of the 1980s.

Governments at all levels continued to be plagued by severe budgetary imbalances in 1992. At the federal level, the unified budget deficit rose about \$20 billion in fiscal year 1992, to a level of \$290 billion. With the economy gradually strengthening, the rate of increase in federal receipts picked up a little, to 3½ percent, from only 2¼ percent in fiscal 1991. However, spending once again rose faster than receipts; total federal outlays were up 4½ percent in fiscal 1992, after a rise of nearly 5¼ percent in the previous fiscal year.

## Federal Unified Budget Deficit



The rates of growth in total spending in 1991 and 1992 may well understate the degree of upward momentum in federal outlays in those years. In 1991, total spending was held down considerably by a convention used in the federal budget to account for the flow of contributions to the United States from its allies in the Gulf War. Those contributions were counted as negative defense outlays, rather than as additions to receipts. Additional contributions from the allied countries were received in fiscal year 1992, but were much smaller than those of 1991. Another important factor at work in 1992, however, was a delay in funding the activities of the Resolution Trust Corporation (RTC), which kept the 1992 outlays for deposit insurance programs much lower than they otherwise would have been.

Excluding the outlays for deposit insurance and the effect of the allied contributions on reported levels of defense spending, federal expenditures rose about 6½ percent in nominal terms in fiscal year 1992, after an increase of nearly 9 percent in fiscal year 1991. Spending for entitlements, especially those related to health care and income support, continued to grow very rapidly in 1992. In the health area, federal outlays for Medicaid increased nearly 30 percent, and spending for Medicare rose 14 percent. Spending for income security was boosted in 1992 by further large increases in unemployment benefits and food stamp disbursements. In dollar terms, the combined rise in outlays for health care and income security amounted to about \$60 billion. Increased expenditures for social security added almost another \$20 billion.

Combined spending for all other programs rose only slightly in fiscal year 1992. Within that broad and diverse grouping, defense outlays fell sharply in nominal terms, once adjustment is made for the allied contributions, but some nondefense functions posted large increases in outlays.

State and local governments saw no relief from budgetary pressures in 1992. The combined deficit in their operating and capital accounts, net of social insurance funds, widened a bit over the first three quarters of the year, reversing the small improvement that had been achieved in the latter part of 1991. As is true at the federal level, a rapidly rising level of mandated transfer payments to individuals for health and income support is at the core of the budget difficulties of many states and localities; in nominal terms, transfer payments in the fourth quarter were about 16 percent above the level of a year earlier.

Construction spending by state and local governments picked up in 1992. According to preliminary

data, the real gain in these outlays amounted to about 3½ percent over the four quarters of the year. Spending for highways increased considerably in 1992, and outlays for buildings other than schools were strong in the first half of the year. Construction of educational facilities, which has been boosted by increases in the school-age population in recent years, rose further in 1992, but the increase was small, both in absolute terms and relative to the gains in most other recent years.

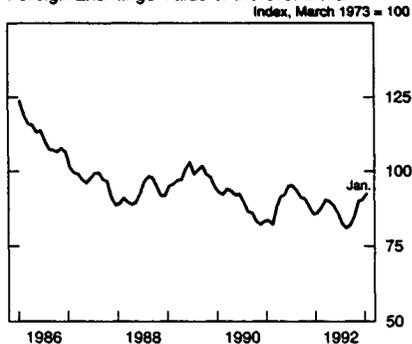
Growth in other major categories of state and local expenditures was restrained. Compensation of employees, which accounts for more than half of total state and local expenditures, increased about 1½ percent in real terms over the four quarters of 1992; in nominal terms, the rise over the year amounted to about 4½ percent, similar to that of 1991 but much less than the nominal increases seen in the years before 1991. Restraint on wage growth was widespread in the state and local sector in 1992, and although total employment in the sector grew a little faster than in 1991, hiring freezes, furloughs, and layoffs continued to be reported in some hard-pressed jurisdictions. State and local purchases of durable and nondurable goods—such things as equipment and supplies—apparently grew little in real terms over the course of 1992. Real purchases of services from outside suppliers apparently edged down for the third year in a row.

Many states and localities have implemented tax increases in recent years in an effort to bolster receipts. In addition, grants-in-aid from the federal government have been rising rapidly, and, in 1992, improvement in the economy helped boost receipts to some degree. In total, state and local receipts rose 7½ percent in annual average terms in 1992, outpacing the growth of nominal GDP by a considerable amount. However, for the third year in a row, the increase in receipts fell short of the annual rise in nominal expenditures, which amounted to 8 percent in 1992.

### The External Sector

The trade-weighted foreign exchange value of the U.S. dollar, measured in terms of the other G-10 currencies, rose nearly 6 percent on balance from December 1991 to December 1992. The dollar increased over the first three months of 1992 amid expectations of strengthening economic recovery in the United States and slowing economic growth abroad. Over the summer, however, the dollar declined to a point below the previous year's low as

Foreign Exchange Value of the U.S. Dollar \*



\*Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of other G-10 countries. Weights are based on 1972-76 global trade of each of the 10 countries.

growth of the U.S. economy was perceived to be more sluggish than expected and as the Federal Reserve eased short-term interest rates further. The dollar reversed direction again in the fall, strengthening sharply in the wake of turmoil in the European Monetary System and, more importantly, on evidence of increased momentum in the U.S. economic expansion and sluggish conditions in foreign industrial economies. The dollar's rise continued into the early weeks of 1993.

On a bilateral basis, the net rise in the weighted-average dollar over 1992 primarily reflected sharp increases in the dollar's value against several European currencies and against the Canadian dollar. Denmark's rejection of the Maastricht Treaty in early June called into question the future of European monetary and political union and led to pressures on the exchange rate mechanism (ERM) of the European Monetary System. In September, those pressures intensified enough to force Italy and the United Kingdom to withdraw from the ERM, and their currencies depreciated sharply. For the year as a whole, the dollar appreciated against those two currencies by 19 percent and 18 percent, respectively. Several other European currencies, including those of Spain, Portugal, and the Scandinavian countries, also depreciated sharply against the dollar in the autumn. The parity of the French franc with the German mark was maintained within the ERM, but at the cost of relatively high French short-term interest rates in the face of a sluggish French economy and rising unemployment.

The dollar fell more than 7 percent against the German mark from December 1991 to August 1992,

as German monetary policy, responding to relatively high German money growth and inflation, remained tight longer than market participants had expected. That decline of the dollar was more than reversed during the fall and winter, however, as it became clear that German economic activity had turned significantly downward and as German monetary policy was eased somewhat. By mid-February 1993, the dollar was about 5 percent higher against the mark than it had been in December 1991.

The dollar depreciated about 6 percent on balance against the Japanese yen during 1992 and early 1993, despite a noticeable decline in Japanese GDP during the second and third quarters and a significant reduction in Japanese interest rates. The net strengthening of the yen probably can be attributed, at least in part, to market reactions to a substantial widening of Japan's external surplus.

The U.S. merchandise trade deficit widened to about \$84 billion in 1992, compared with \$65 billion in 1991 (Census basis). Imports grew about twice as fast as exports as the U.S. economic recovery gained some momentum while economic growth in U.S. markets abroad was sluggish on average. Early in the year, the deficit narrowed somewhat when a drop in oil prices lowered the value of imports. The deficit widened sharply in the second quarter, however, when imports surged and exports remained about unchanged. During the second half of 1992, imports continued to expand somewhat more rapidly than exports, and the deficit increased further.

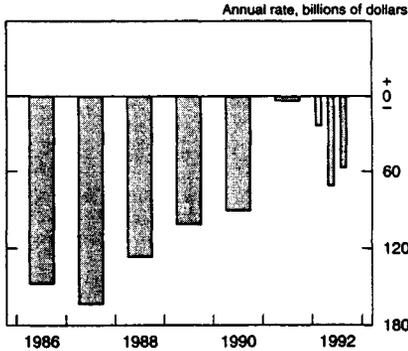
The current account balance worsened substantially more than the trade deficit, moving from near balance in 1991 to a deficit of \$51 billion at an annual rate over the first three quarters of 1992. However,

one-time cash transfers associated with the Gulf War accounted for most of the difference; these transfers had reduced the current account deficit by \$42 billion in 1991, but they reduced it by only about \$2 billion at an annual rate during the first three quarters of 1992. Excluding these transfers, the current account deficit weakened somewhat less than the trade deficit, owing to a strengthening of net service receipts.

U.S. merchandise exports grew 4½ percent in real terms over the four quarters of 1992. Most of the increase occurred in the second half of the year and consisted largely of stronger shipments of agricultural goods, computers, other machinery, and automotive products. Excluding agricultural products and computers, the quantity of exports grew only 1 percent in 1992 compared with a rise of 6½ percent in 1991; this slowdown was mainly a reflection of sluggish demand in key industrial countries. By region of the world, most of the increase in exports during 1992 went to areas that continued to register moderate to fairly strong rates of economic growth—primarily developing countries in Asia and Latin America. Exports to Japan and to European countries, whose growth rates probably averaged less than 1 percent when weighted by the shares of those countries in U.S. exports, actually declined in 1992.

Merchandise imports grew 10½ percent in real terms during 1992. Two categories—oil and computers, the latter of which includes peripherals and parts—accounted for a significant portion of that rise. Oil imports rose 13 percent over the four quarters of 1992 as U.S. consumption of petroleum products recovered from depressed levels in 1991 and as domestic oil production resumed its long-run downward trend. U.S. domestic sales of computers were very strong beginning in the summer, fueled by price wars

U.S. Current Account



U.S. Real Merchandise Trade



and by a push on the part of U.S. businesses to upgrade PCs and workstations to take advantage of improvements in software. Most of the sales were in the lower end of the spectrum of computer products—items that often are imported. Imports of products other than oil and computers increased 5¼ percent in 1992 as domestic demand in the United States picked up. The strongest increases were in a wide range of consumer goods, especially from China and various other developing countries in Asia. Imports of telecommunications equipment, electric machinery, and other types of machinery also showed significant increases in 1992, for the first time since 1988.

For the first three quarters of 1992, the substantial current account deficit was more than matched by recorded net capital inflows, both official and private. Net official inflows amounted to more than \$30 billion at an annual rate, despite substantial net outflows associated with intervention sales of dollars by major foreign industrial countries. Net private inflows were almost as large, with banks accounting for a large part of these inflows. The agencies and branches of Japanese-based banks used funds from abroad to substitute for a run-off in CDs outstanding in the United States while other foreign-based banks used funds from abroad to help finance asset expansion in the United States. A reduction in the holdings of Eurodeposits by U.S. residents also contributed to the net private capital inflow during the first three quarters of the year, but that reduction was partially reversed in the fourth quarter.

Although securities transactions contributed little to the net inflow of capital in the first three quarters of 1992, the continued impact of the globalization of financial markets was apparent. U.S. net purchases of foreign stocks and bonds were very strong, accompanied by a near record pace of foreign bond issues in the United States. During the same period, foreigners added substantially to their holdings of U.S. government and corporate bonds; however, they made net sales of U.S. equities.

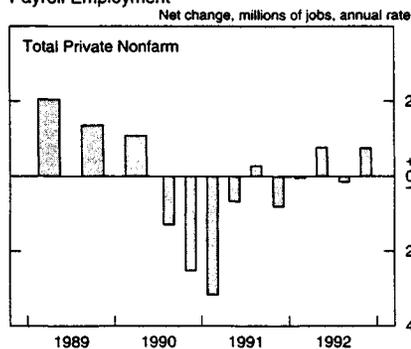
U.S. direct investment abroad was very strong in the first three quarters of 1992. Outflows to Europe remained high, while outflows to Latin America and Asia grew. In contrast, foreign direct investment in the United States fell further, producing a net outflow. The rate of new foreign direct investment in the United States has declined dramatically in recent years from large inflows recorded during the latter part of the 1980s, partly reflecting the sharp drop in mergers and acquisitions in the U.S. business sector. In addition, the very low rates of return reported by

foreign direct investors on their holdings in the United States in recent years may have helped to discourage new investment.

### Labor Market Developments

The labor market remained relatively sluggish in 1992. Some large companies continued to undergo major restructurings or reorganizations, and these changes led in many cases to permanent workforce reductions at those firms. More generally, businesses remained hesitant to take on new workers, even as the recovery progressed. The still-sluggish pace of output growth in the first half of the year tended to limit labor requirements during that period. Later on, when firms started to expand output more rapidly, they were able to do so without making major long-term hiring commitments. Needs for additional workers were met, in many cases, through use of temporary-help firms, rather than through permanent additions to companies' own payrolls.

### Payroll Employment



Nonetheless, the tilt of the overall employment trend was positive, rather than negative as it had been in 1990 and 1991. Payroll employment, a measure that is derived from a monthly survey of business establishments, was up about 600,000 during 1992 and an additional 100,000 in January. The number of jobs in manufacturing fell further in 1992, but not as much as in either of the two previous years; small increases in the number of factory jobs were reported toward year-end and in early 1993. In addition, employment in construction changed little in 1992, after two years of sharp decline.

About 900,000 new jobs were created in the service-producing sector of the economy in 1992. The number of jobs in retail trade turned up a little, on net,

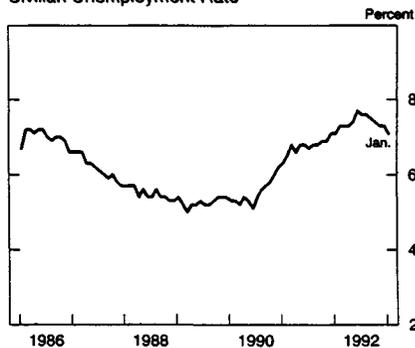
after dropping about one-half million over the two previous years. In addition, firms that provide services to other businesses recorded strong employment growth in 1992; more than likely, these firms were the ones that benefited most from the tendency of businesses to purchase labor and services from other firms, rather than hiring additional workers of their own. Employment in health services, which had remained on a strong upward trend right through the recession, continued to grow rapidly in 1992.

The employment measure that is derived from the monthly survey of households was stronger than the payroll measure in 1992; it showed an increase of about 1½ million in the number of persons holding jobs and, by year-end, had moved back close to the previous cyclical peak of mid-1990. Reasons for the stronger performance of the household series are not entirely clear. Differences in coverage between the household survey and the payroll survey accounted for only a small part of the 1992 gap, and other possible explanations are little more than conjecture at this point. A portion of the gap between the two series was eliminated in January, as the rise in jobs reported in the payroll survey in that month was accompanied by a decline in the household measure of employment.

The number of unemployed persons increased in the first half of 1992, to a peak in June of nearly 9.8 million. Job losses—many of them apparently permanent—continued to mount in the first half of the year, and new job opportunities did not open up fast enough to fully absorb either those workers or others entering the work force for the first time. As a result, the unemployment rate rose more than ½ of a percentage point in the first half of the year, to a June level of 7.7 percent.

The second-half outcome was more favorable. The number of unemployed persons declined about ½ million from June to December, and the unemployment rate moved down over that period, to a level of 7.3 percent at year-end. Some of the workers who had been laid off temporarily were recalled in the second half of the year. In addition, the number of unemployed workers not expecting to be recalled—the so-called permanent job losers—also declined; presumably, these workers either found new jobs elsewhere in the economy or dropped out of the labor force altogether. A similar story also applied to unemployed new entrants, a category of jobless workers whose ranks were a little thinner at the end of 1992 than they had been at mid-year. In January of this year, the number of unemployed persons fell

Civilian Unemployment Rate

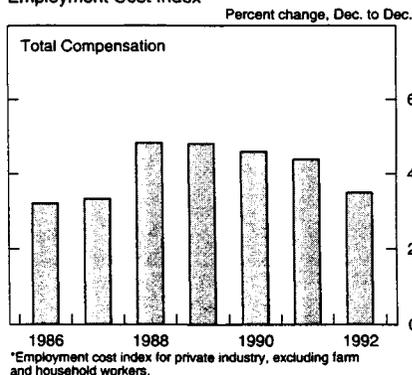


further, and the unemployment rate edged down to 7.1 percent.

In the aggregate, the civilian labor force—the sum of those persons who are employed and those who are looking for work—rose sharply in the first half of 1992, but changed relatively little thereafter. Its level in January of 1993 was up about 1 million from that of a year earlier. The labor force participation rate—the proportion of the working-age population that is in the labor force—fell over the second half of the year and into January of 1993, leaving it about where it had been at the end of 1991.

Against a backdrop of slack in labor markets and in the context of reduced inflation, the rate of rise in workers' hourly compensation continued to slow in 1992. The employment cost index for private industry—a measure of labor cost that includes both

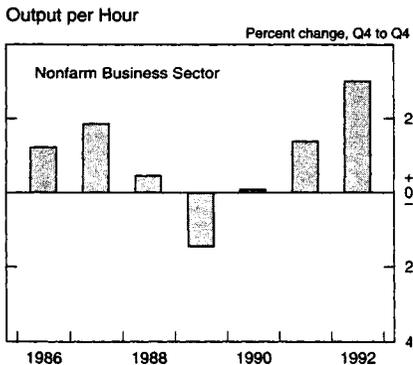
Employment Cost Index \*



wages and benefits and that covers the entire nonfarm business sector—increased 3½ percent from December of 1991 to December of 1992. The index had risen nearly 4½ percent in the previous twelve-month period, and, as recently as mid-1990, its twelve-month rate of change had exceeded 5 percent. The employment cost index for wages and salaries increased only 2.6 percent during 1992; this was the smallest annual rise ever reported in this measure, which dates back to 1975. The rate of rise in the cost of benefits provided by firms to their employees also slowed in 1992, but the size of the increase—5¼ percent—was still relatively large. Many firms, both large and small, continued to be pressured by the rising cost of medical care for their employees and by the increased cost of workers' compensation insurance; the difficulty of bringing these costs under control may well have been a serious deterrent to increased hiring in 1992.

Despite the further slowdown in nominal compensation per hour in 1992, the purchasing power of an hour's labor would appear to have risen in real terms, as the nominal increase in hourly wages and benefits, as measured by the employment cost index, outpaced the rise in consumer prices for the second year in a row. Real compensation, computed in this manner, had declined sharply in 1990, and the increase in 1989 had been barely positive.

Sustained increases in real living standards depend ultimately on achieving advances in the productivity of the workforce, and on that score, the economy performed well in 1992. Output per hour worked in the nonfarm business sector jumped 3 percent over the year, the largest annual gain since 1975. While a portion of this large rise is no doubt a reflection of

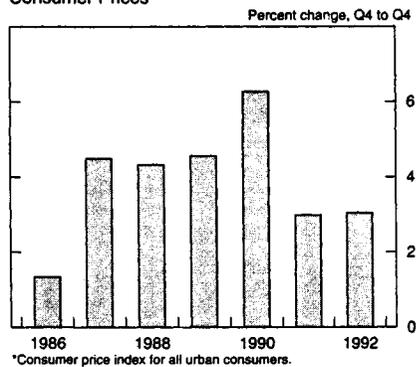


normal cyclical tendencies, longer-range improvement in productivity growth also may be in progress. The jump in output per hour in 1992, combined with the slowing of compensation gains, held the annual increase in unit labor costs to just 0.7 percent.

### Price Developments

The consumer price index rose 3 percent over the four quarters of 1992, the same as in the previous year. Energy prices, which had fallen in 1991, turned up a little in 1992, but price increases elsewhere in the economy were generally smaller than those of the previous year. The limited rise in labor costs in 1992 was one important factor exerting restraint on the rate of price increase. In addition, the cost of materials used in production rose only moderately over the year, as did the prices of goods imported from abroad.

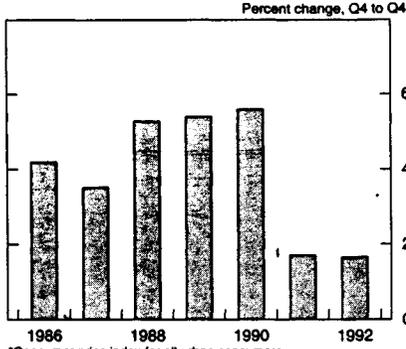
### Consumer Prices\*



Although inflation expectations, as reported in various surveys of consumers and business officials, have remained a step or so above actual inflation rates, they too appear to have moved lower over time. On average, their recent levels are about in line with—or, according to some surveys, less than—the lower bound of the range of inflation expectations reported during the 1980s. In view of these recent trends in prices, labor costs, and inflation expectations, the January rise of 0.5 percent in the CPI would appear to be something of an aberration.

The CPI for food increased a bit less than 1¼ percent in 1992, the same as in 1991. Not since the 1960s has there been a two-year period in which the cumulative increase in food prices was so small. This low rate of food price inflation in 1991 and 1992 was, in part, a reflection of the same factors that were

Consumer Food Prices\*



\*Consumer price index for all urban consumers.

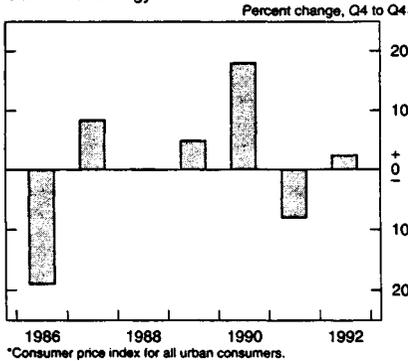
working to pull inflation down in other parts of the economy. In addition, food prices have been restrained by favorable supply conditions in the farm sector. Meat production rose further in 1992, and the output of crops soared. Dryness in some regions imparted temporary volatility to crop prices in late spring. Thereafter, growing conditions turned exceptionally favorable and remained so through the summer and into early autumn. Unusually wet conditions in some regions later on in the autumn apparently made only a small dent in the eventual size of the harvest.

The rise in consumer energy prices over the four quarters of 1992 amounted to about 2½ percent. The previous year, energy prices had fallen 8 percent. With no major supply or demand shocks springing up

in world oil markets in 1992, the price of West Texas Intermediate stayed in the relatively narrow trading range of about \$18 to \$23 per barrel; the price has remained in that range in the early part of 1993. At the retail level, price changes for petroleum products were mixed in 1992; the price of gasoline rose about 3 percent, while fuel oil prices declined moderately. The CPI for natural gas rose about 5 percent in 1992, considerably more than in other recent years. Although much of that rise in gas prices came in the second half of the year in the wake of supply disruptions caused by Hurricane Andrew, prices of gas at the wellhead had already moved up considerably before the hurricane hit, in response to a somewhat tighter supply-demand balance than had existed over the previous year or so.

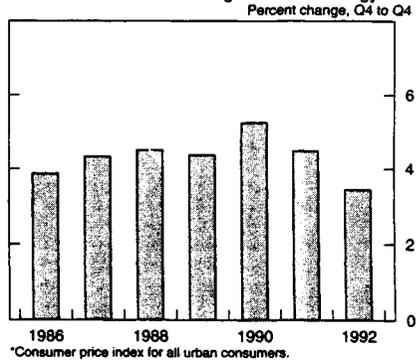
The CPI excluding food and energy rose 3.4 percent over the four quarters of 1992, a percentage point less than it had risen in 1991. The slowdown was widespread among the various categories of goods and services that are included in this measure of core inflation. The rate of rise in the cost of shelter—the single most important category in the CPI, with a weight equal to more than one-fourth of the total—slowed further in 1992; rents for both apartments and houses apparently were damped by the large amount of vacant housing that was available in many parts of the country. The prices of other services that are included in the CPI—which collectively make up another one-fourth of the total index—also slowed appreciably in 1992. Nonetheless, their overall rate of increase remained relatively high. The costs of medical care services and tuition continued to rise much faster than prices in general in 1992, and air

Consumer Energy Prices\*



\*Consumer price index for all urban consumers.

Consumer Prices Excluding Food and Energy\*



\*Consumer price index for all urban consumers.

fares rebounded from their 1991 decline. The CPI for commodities other than food and energy rose 2½ percent during 1992, after an increase of more than 4 percent over the four quarters of 1991. Price increases for this broad category of goods were restrained by the cost and price developments in manufacturing: Unit labor costs in manufacturing actually declined in 1992, and the producer price index for finished goods rose less than 2 percent.

After falling sharply from mid-1990 to the end of 1991, the prices of industrial commodities generally changed little, on balance, during 1992. By the end of 1992, however, prices had begun to tilt up for some industrial metals, consistent with the pickup in the pace of industrial expansion toward year-end, and additional price increases have been reported in some of these markets in early 1993. The prices of lumber and plywood—following a path considerably different from that of most other commodities—rose substantially during 1992, and further steep increases have been evident in early 1993. The surge in prices of these products appears to be a reflection of the

uptrend in single-family housing construction, weather-related supply disturbances in some timber regions, and adjustment of the logging industry to environmental restrictions that have been implemented in some areas of the country. Prices of some other wood products, such as pulp, also rose sharply at the producer level in 1992.

The recent increases in prices of these raw materials have shown through to some extent to broader measures of producer prices. For example, the producer price index for intermediate materials excluding food and energy—a price index that encompasses a wide range of production materials—rose 1 percent during 1992, after declining about ¼ of a percentage point during 1991, and the past couple of months have seen some further pickup in that measure of price change. From an economy-wide perspective, however, that pickup in materials prices has not been sufficient to dominate the deceleration in labor costs, which account for a far greater share of total production costs.

### Section 3: Monetary and Financial Developments in 1992

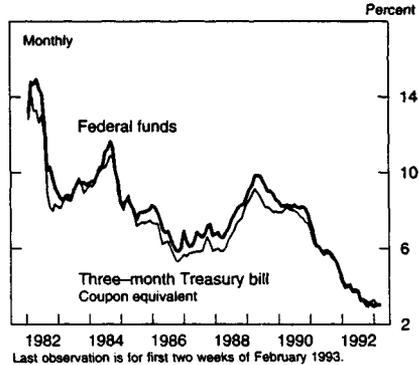
Federal Reserve policy in 1992 was directed at promoting and extending the recovery from the 1990–91 recession, in the context of continued progress toward price stability. The difficulty of designing and implementing constructive monetary policies has been exceptional in this period. In 1992, as earlier, economic activity was held back to an unusual degree by the efforts of households, nonfinancial businesses, and some key providers of credit to the economy, including commercial banks, to strengthen their balance sheets. These forces have tended to alter the normal relations between financial flows—particularly those reflected in movements in M2 and M3—and the behavior of the economy. Under the circumstances, the Federal Reserve has had to take a flexible approach to the use of money and credit aggregates as intermediate policy targets; specifically, in light of evidence that expansion in economic activity was being financed to an unusual extent in capital markets rather than through banks and other depositories, the System tolerated shortfalls of M2 and M3 from their target ranges.

The Federal Reserve judged it appropriate to ease reserve conditions on three occasions in 1992, when financial and economic data suggested that the economy might be losing momentum. The extent of the easings last year was considerably less than in 1991, however, as the underlying trend of the economy overall was more positive. Partly as a result of the cumulative effect of the monetary easings of recent years, economic activity accelerated in 1992 to its fastest pace since 1988. This pickup was achieved even as various measures of inflation evidenced further slowing, with the “core” inflation rate falling to levels last seen in the early 1970s. Thus, 1992 was a year not only of financial repair, but also of improved aggregate economic performance in the United States.

#### The Implementation of Monetary Policy

Nineteen ninety-two began with short-term interest rates at their lowest levels in over a quarter of a century, following a series of actions by the Federal Reserve in the latter part of 1991 that reduced the discount rate and the level around which the federal funds rate was expected to trade to 3½ and 4 percent respectively. Long-term rates were also at lower levels, reflecting the policy actions and a weakening of economic activity in the final quarter of 1991.

#### Short-Term Interest Rates



Evidently in the expectation that these rate cuts would revive the recovery, the stock market began the year with strong upward momentum, and the dollar appreciated. However, other evidence that the economy was picking up remained scanty in the initial part of the year, despite the significant monetary stimulus already in place and the positive developments in equity and capital markets. Apart from rising housing starts, a phenomenon in part related to special weather and tax factors, the economy appeared sluggish and confidence levels were low. Spending by households and businesses seemed to be restrained by efforts to strengthen financial positions, and banks had done little to reverse the substantial tightening of lending standards that occurred in 1990 and 1991. In view of the still tentative nature of the recovery and the solid progress that had been made to that point against inflation, the Federal Open Market Committee (FOMC) at its first meeting of the new year instructed the Manager of the Open Market Account at the Federal Reserve Bank of New York to remain especially alert to evidence that money market conditions might need to be eased before the next scheduled meeting of the Committee. Such a policy stance biased toward ease had prevailed over much of 1991.

M2 and M3, which had posted moderate gains in January, surged in February, owing partly to stronger income and earlier sharp declines in short-term interest rates, and partly to special factors—above-average tax refunds and a jump in mortgage refinancing, which results in funds being held temporarily in demand deposits. Underlying money growth remained very weak, however, and well below that consistent

with expectations based on the historical relationship of money with income, deposit rates and market interest rates. In March, as the influence of the special factors abated, M2 was about flat and M3 contracted.

The economy seemed to be improving during much of the first quarter: retail sales and housing starts were strong, industrial production turned up, and confidence levels of the business and household sectors were rising as was the quality of their balance sheets. The signs of recovery and the market view that the prospects for further near-term monetary ease had faded caused long-term interest rates to increase, and the dollar rose on foreign exchange markets as well. Increases in private interest rates were less than those on Treasuries, likely reflecting perceived reductions in the riskiness of private debt as the economy strengthened coupled with concerns about enlarged Treasury demands on credit markets stemming from discussions of possible fiscal stimulus. Areas of weakness in the economy remained, however—some attributable to the substantially overbuilt commercial real estate sector and some to the transition to a smaller defense sector. In addition, the backup in long-term interest rates threatened to slow the pace of balance sheet adjustment and could damp housing and its related industries as well as business investment spending, and the outlook for exports clouded.

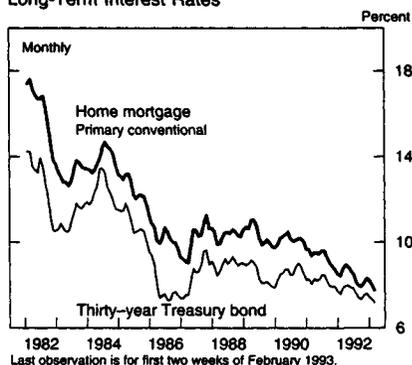
In early April, the System eased reserve conditions again. This action was taken on indications that the monetary aggregates, already at the bottom of their target ranges following their flat performance in March, were beginning to contract, that the balance of evidence was beginning to suggest a slowing in the economic expansion, and that inflation was continuing to recede. Short-term interest rates fell more than the ¼ point drop in the trading level of the federal funds rate, as market participants judged the economy sufficiently weak to make further near-term monetary easing moves likely. The easing buoyed the stock market, but long-term rates showed a limited response and remained well above year-end levels.

In the weeks following the easing, the economy appeared to improve a bit but the evidence continued to be mixed. Single-family housing starts, which had contracted in March, fell considerably further in April and retail sales were little changed on balance between February and April. On the other hand, nonfarm payroll employment and industrial production continued to expand. Weakness in the monetary aggregates persisted into April, but concerns on this front were allayed to some degree by evidence that this was importantly related to the ongoing

re-channeling of credit away from depository institutions and into capital markets, and by expectations that this re-channeling and other financial restructuring would continue to damp money growth considerably more than economic activity. Moreover, what restraint balance sheet restructuring was exerting on spending was seen as likely to abate in view of the considerable progress that by then had been made in this area, both by the borrowing sectors and by depository institutions, as banks added rapidly to capital. At its mid-May meeting, the Committee determined that its bias towards ease in assessing possible intermeeting policy changes was no longer appropriate.

Data becoming available over subsequent weeks, however, suggested that the forces restraining economic expansion continued to be quite strong. The contraction of consumer credit accelerated, and bank loans more generally began to run off. With the forces that had been constraining money growth intensifying, all three monetary aggregates contracted in June.

### Long-Term Interest Rates



Nonfinancial data confirmed that the economy remained slack. Although nonfarm payroll employment and industrial production each increased in May for the fourth straight month, the unemployment rate rose sharply, owing to a rising labor force participation rate. Moreover, homebuying and retail sales, other than for automobiles, slowed from the pace earlier in the year, and demand for U.S. exports was held down as growth in some foreign industrial countries slowed or turned negative while other countries struggled to recover from their downturns in 1991 or remained in recession.

With the tenor of incoming economic news having become distinctly negative, long-term Treasury rates,

which had been little changed over most of May and June, turned down around mid-year, although they remained above year-end lows. In light of these developments, and with the downward trend in inflation continuing, the System reinstated its bias towards ease at its mid-year meeting. Immediately following that meeting, on July 2, with evidence of a weakening economy confirmed by a further rise in the unemployment rate, to  $7\frac{3}{4}$  percent in June, the Federal Reserve reduced the discount rate and the federal funds rate each by  $\frac{1}{2}$  percentage point, to 3 and  $3\frac{3}{4}$  percent, respectively. Banks lowered their prime rate, also by  $\frac{1}{2}$  percentage point, to 6 percent, leaving its unusually wide spread over market rates intact.

Long-term interest rates fell in response to the employment data and the monetary easing and moved down further into early August as the incoming economic news continued to be poor. The drop in yields brought long-term rates to the lowest levels since the early 1970s, and the dollar continued to retreat from its peak levels reached in April.

In early September, with another weak labor report and in the context of contracting industrial production and expansion in the monetary and credit aggregates that, while now positive, was weaker than had been expected, reserve conditions were eased further and the federal funds rate fell to around 3 percent. Shorter-term market rates dropped on this action, bringing them to the neighborhood of zero in real terms. Despite the poor economic news and expectations that further easing moves were in the offing, long-term rates, although they initially declined, drifted back up on renewed concerns that the federal deficit would be enlarged by fiscal actions taken to stimulate the economy.

Throughout the late summer and early fall, policy was conducted against a background of tension in foreign exchange markets; a strong Deutschemark had caused several European countries to raise interest rates sharply to preserve fixed exchange rate relationships with and within the exchange rate mechanism (ERM) of the European Monetary System at a time when aggregate demand in these countries was slowing or sluggish. The dollar continued to decline into early September, but then began to firm. The rise in long-term rates contributed to the reversal, as did actions by several European countries to devalue their currencies, in some cases dropping out of the ERM, and to lower interest rates.

With short-term interest rates in the United States lower, the monetary aggregates continued to expand in September. The implications of the strength of M2

were difficult to assess, however, since it reflected to an uncertain degree the impact of mortgage refinancing on demand deposits as well as strong foreign demands for U.S. currency. Stronger income also appeared to be contributing to money growth, as private employment edged up and the unemployment rate declined in September. Nevertheless, the outlook for the economy remained uncertain. Final demand seemed weak and was being met in part through higher imports, holding down industrial production and employment, and business and consumer sentiment remained relatively depressed.

In these circumstances, the FOMC established a strong bias toward ease at its early October meeting. In the event, however, an improvement in economic indicators immediately following the meeting, along with evidence of some strength in M2 and bank credit, stayed any further easing actions. Since anticipation of further easing had been built into the structure of interest rates, short-term rates backed up following the meeting. Rates also rose at the long end, responding to growing expectations that fiscal stimulus could follow the upcoming presidential election, as well as to the indications of improved economic performance.

Evidence of greater economic strength continued to accumulate in a variety of indicators of production and spending over the fourth quarter. Although this news initially put further upward pressures on longer-term interest rates, these came to be muted and then reversed as the better economic prospects, along with statements and actions of the incoming Administration, began to be viewed as reducing the likelihood of oversized fiscal stimulus. Also helping to lower longer-term rates was continuing good news on inflation. These factors, buttressed by an increasing focus in public discourse on reducing the federal deficit, continued to play an important role as long-term rates fell further into the new year.

With the better economic news, the Federal Reserve kept reserve conditions and short-term interest rates unchanged as the year ended, and the FOMC at its December meeting decided to move back to a symmetric policy stance. Reflecting the improved economic outlook, a stock market rally developed that rivaled in strength that which began the year, and the dollar rose further.

Although the monetary aggregates strengthened a bit in the fourth quarter, the depressing effects of balance sheet restructuring continued to be important, a fact that became clearer once the hard-to-measure temporary boost to deposits deriving from

higher mortgage refinancing abated after October. The velocities of both M2 and M3 rose significantly further in the final quarter of the year, contributing to the exceptional velocity increases posted by both measures for the year as a whole.

### Monetary and Credit Flows

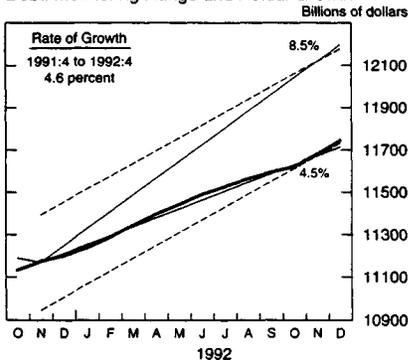
Credit flows again were quite damped in 1992, and money growth was exceptionally weak. Despite an appreciable pickup in nominal GDP growth last year, the broad monetary aggregates decelerated further, and expansion of the nonfinancial debt aggregate edged up only a bit. As had been the case for the last couple of years, considerable efforts by key sectors of the economy to improve balance sheets had a significant restraining effect on credit and, especially, on money growth—a much greater effect than they had on spending itself. Growth of the debt of nonfinancial borrowers other than the federal government edged up by only ¼ percentage point from 1991, to 2½ percent, as businesses and households restrained borrowing and financed spending out of cash flow and equity issuance and by limiting accumulation of financial assets. The expansion of federal debt slowed slightly to a still rapid 10¾ percent, held down by the lack of activity by the Resolution Trust Corporation (RTC) after April, when it exhausted its legislative authority to fund losses at savings and loans. Reflecting the slowdown in the activities of the RTC and the improving health of depositories, federal outlays attributable to deposit insurance activity fell from the \$50 billion area in 1991 to nil last year. The total nonfinancial debt aggregate expanded about 4½ percent last year, at the lower end of its monitoring range.

The sluggishness in credit and money growth last year appeared to represent mainly weak demand, rather than any new tightening of credit supply terms. At banks, loan flows were depressed, and, in the absence of appreciable credit demands, bank asset growth mainly took the form of security acquisitions. Some have argued that the shift to government securities over recent years has been motivated by the Basle risk-weighted capital standards, which require capital against loans but not against many government securities. However, the effect of these standards appears to be relatively minor. As in 1990 and 1991, banks that had already achieved adequate capital positions were the major purchasers of U.S. Treasury and agency securities last year, and loan flows were depressed at these banks as well. Moreover, other regulatory factors may be contributing to a reduction in willingness to take deposits and make loans, including rising deposit insurance premiums and the tighter regulations and requirements of new laws governing banks and thrifts in recent years. A similar pattern of asset growth concentrated in government securities occurred at credit unions, which are not subject to the Basle capital standards. Although loan growth at banks remained lackluster, it strengthened in the final quarter of the year as the economy began to expand more rapidly. At the same time, the growth of bank holdings of government securities, which had been very rapid all year, slowed.

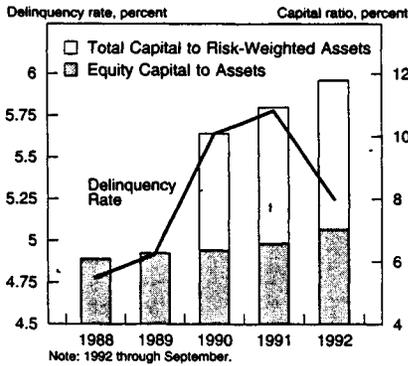
To be sure, the pickup of bank lending toward year-end seemed primarily related to stronger demand—banks gave little indication in Federal Reserve surveys that they had begun to ease the tighter lending standards and terms that they had put in place in 1990 and 1991, and the unusually wide spread of the prime rate over market rates persisted. Banks do seem better positioned to meet increases in demand than they were a few years ago. Not only has their liquidity improved with the acquisitions of government securities, but they have made substantial progress in improving capital positions, including leverage ratios—which are unaffected by asset composition—as both profits and debt and equity issuance reached record levels in 1992. Moreover, the quality of their assets showed some scattered signs of improvement last year; the delinquency rate for bank loans, though still high, began to turn down, as did the rate of charge-offs.

Other financial intermediaries also have taken steps to strengthen balance sheets, and the availability of credit from these lenders also remains somewhat constrained—though probably not more so than in 1991. Life insurance companies, for example, have

Debt: Monitoring Range and Actual Growth



**Commercial Bank Loan Delinquency Rate and Capital Ratios**



suffered from an abundance of bad loans and remain saddled with poor quality commercial real estate loans. Such firms have been limiting acquisitions primarily to high quality, easily marketable assets, meaning that, as in 1991, some medium-sized, below-investment-grade companies found credit from life insurance companies difficult to obtain in 1992. Some business finance companies also have experienced high and rising levels of nonperforming loans, many of which were secured by commercial real estate, with effects on their willingness to make new loans.

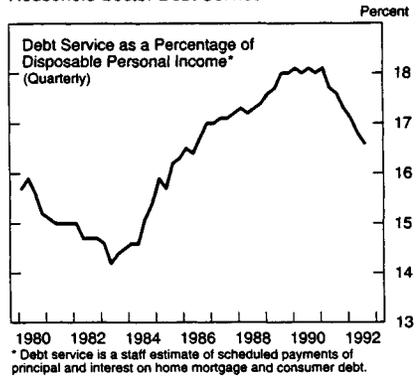
Downgradings of the manufacturing parents of automobile sales finance companies have led to some increases in their funding costs. To date, however, there has been little or no effect on the cost or availability of consumer credit, as these finance companies have increased the volume of loans they have securitized. The availability of credit at thrift institutions likely improved a bit last year. Reflecting the declines in interest rates, profits of private sector savings and loans had reached a record level as of the third quarter, sustained by a wide spread between interest earned on assets and the cost of funds, as well as by a decline in the industry's still high level of troubled assets.

Weak credit demand and constraints on some sources of supply have produced generally sluggish borrowing in each major nonfinancial sector other than the federal government. Overall household borrowing accelerated slightly but continued moderate, as demand was depressed by insecurity about employment as well as by efforts to restructure balance

sheets. Declines in mortgage rates promoted only about a 1/2 percentage point boost to net home mortgage growth, but they spurred a substantial volume of refinancing. Some of the proceeds of mortgage refinancings likely were used to pay down higher-cost consumer credit. Consumer credit also was held down last year as households apparently used funds that otherwise would have been held in low-yielding deposits to reduce high-cost debt.

With the pace of debt accumulation by the household sector damped, and with rates on consumer debt falling and mortgage debt being refinanced at lower rates, the ratio of debt servicing payments to household income declined considerably further last year. Another sign of improving household financial conditions has been recent trends in delinquency rates. Consumer loan delinquency rates mostly fell last year, although they remain at high levels. Home mortgage delinquency rates were little changed on balance last year and still somewhat above their pre-recession levels, but well below those of the mid-1980s.

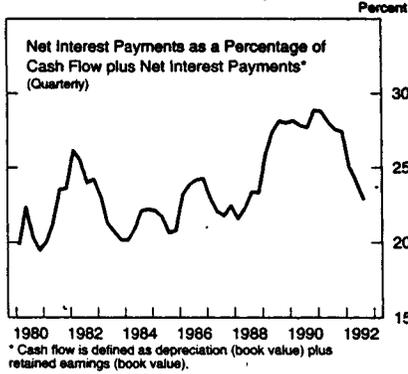
**Household Sector Debt Service**



Business debt grew only slightly last year as internally generated funds exceeded investment spending. Taking advantage of the strong stock and bond markets, nonfinancial corporations stepped up their equity issuance and refinanced large volumes of longer-term debt at more favorable rates. In part, the proceeds of these issues were used to pay down short-term debt, particularly bank loans, thereby lengthening liability structures.

The hospitality of the capital markets extended even to lower-graded business borrowers, which

**Business Sector Net Interest Payments**



economy advanced, corporate debt ratings began to improve and quality spreads narrowed.

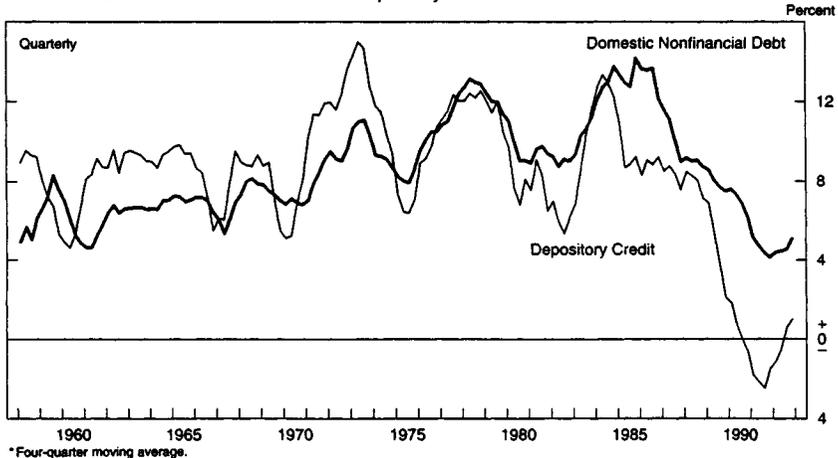
The state and local sector also benefited from the rate declines last year, with large amounts of debt being refinanced, including a large volume that was called. Net debt growth continued to be moderate, however, as this sector's spending remained constrained.

Although balance sheet restructuring has damped credit flows and spending, its greatest impact has been on the monetary aggregates, as an unusually high proportion of spending in recent years has been financed outside the depository system, whose liabilities make up the bulk of the monetary aggregates. Some of this spending has been supported through sources other than borrowing, for example, issuing equity or restraining the accumulation of liquid assets. Depository credit expanded last year, following two years of contraction, but it continued to shrink as a share of nonfinancial debt as borrowers concentrated their credit demands in long-term securities markets—bonds for corporations and fixed-rate mortgages for households.

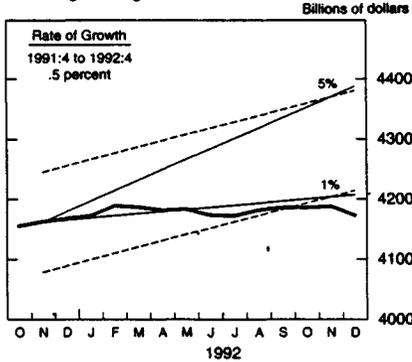
issued substantially more bonds than in recent years. Overall public gross bond issuance by nonfinancial corporations was well above the 1991 level. Likewise, gross equity issuance by nonfinancial corporations also rose from the already high pace of 1991 and was four times that of the late 1980s and early 1990s. As a result of debt refinancing and sales of equity, corporate net interest payments as a percent of cash flow fell for the second year. As declining interest rates allowed firms to reduce debt burdens, and as the

The sluggish expansion of depository credit was echoed in M3, which comprises most—though not all—of the instruments depositories use to finance their credit extensions. In fact, growth of M3 slowed last year to ½ percent despite the pickup in depository credit, as depositories relied much more on equity

**Growth of Domestic Nonfinancial Debt and Depository Credit\***



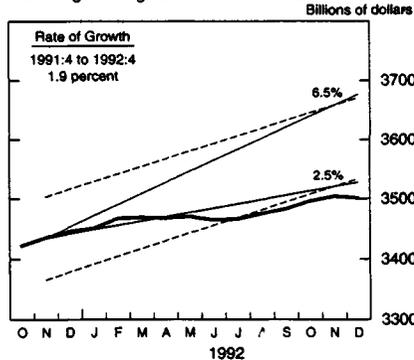
**M3: Target Range and Actual Growth**



issuance and sales of subordinated debt, which are not in M3. Large time deposits at banks and thrifts fell rapidly. The tendency for spending to be financed outside of depositories, along with the latter's reliance on non-M3 funds, produced a sizable increase in M3 velocity last year—at a rate far above that of recent years. The rise in velocity of M3 would have been even greater had it not been for strong inflows into institution-only money funds over the first three quarters of the year. The attractiveness of these funds increases when short-term interest rates are falling, a phenomenon caused by the fact that the funds do not mark to market, so that their yields tend to exceed market rates when those rates are declining.

M2 increased 2 percent last year, below the 2½ percent lower end of its target range. M2 registered

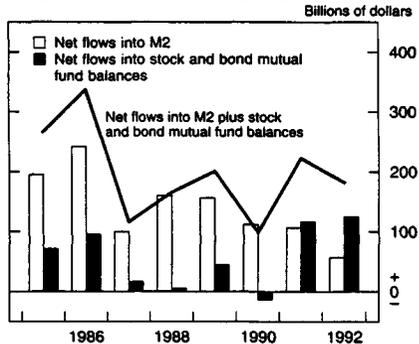
**M2: Target Range and Actual Growth**



modest growth in the first and last quarters of the year, but was about flat over the middle quarters. The reasons for underlying weak money growth appeared to stem from several important factors, many related to the unattractiveness of holding funds in M2 assets relative to other possible uses of savings.

Contributing to the relative attractiveness of non-monetary assets was the rapidity with which banks adjusted down offering rates on retail deposits as market rates declined last year. Banks' unaggressive pricing of deposits reflected substantial paydowns of bank debt by households and businesses, which kept loan demand low and banks' need for funds to finance them quite limited. In addition, banks and thrifts have been discouraged from going after deposits by the rising cost of issuing deposits to make loans; among the factors accounting for this increase have been increases in deposit insurance rates and higher capital ratios occasioned by market and regulatory forces.

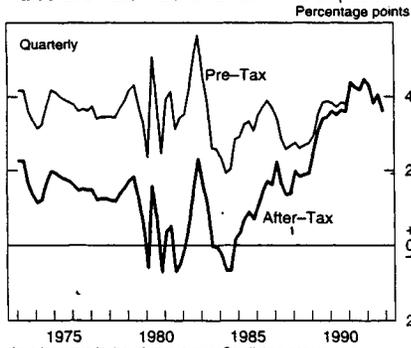
**M2 and Stock and Bond Mutual Fund Balances**



Note: Mutual fund data exclude IRA and Keogh balances and institutional holdings. IRA and Keogh balances and institutional holdings for 1992 are estimated.

The prompt declines and low level of deposit rates have combined with several other factors to induce savers to cut back on holdings of assets in M2. One important influence was the unprecedented steepness of the yield curve, which was pulling deposit funds into capital markets. An important method for accomplishing this portfolio shift was mutual funds, which experienced record inflows last year. Not only were yields on these funds attractive, but they have become increasingly available through banks and thrifts. Assets in bond and equity mutual funds (apart from those held by institutions and those in IRA and Keogh accounts) increased \$125 billion last year, up from \$117 billion in 1991 and an average of \$30 billion

Spreads between Pre- and After-Tax Auto Loan Rates and Rate Paid on Small Time Deposits



Auto loan rate is the 48-month rate. Small time deposit rate is for maturities of two and a half years and over.  
Marginal federal tax rates based on John Seater, "On the Construction of Marginal Federal Personal and Social Security Tax Rates in the U.S.," *Journal of Monetary Economics* 15 (1985) pp. 121-35.

over the previous five years. In 1991 and 1992 for the first time, increases in mutual fund assets exceeded increases in M2.

Money growth has also weakened as consumer loan rates have moved downward less rapidly than deposit rates. As a consequence, households face a considerable interest rate incentive, particularly after taking account of changes in the tax deductibility of consumer interest payments, to use funds in deposit accounts to pay down, or limit the accumulation of, debt. In fact, the rise in consumption has been accompanied by an unusually small increase in debt, implying that it has been financed to a large extent by reducing or limiting holdings of financial assets.

The cuts in bank deposit rates were particularly evident for larger (and presumably more interest sensitive) accounts and at longer maturities. Small time deposits ran off throughout the year. Some of these funds appeared to flow into more liquid deposit accounts, as small time deposit rates fell faster than those on savings and checkable deposits. General purpose and broker-dealer money market mutual funds (MMMFs) also contracted over the year, despite the yield advantage these assets offered vis-à-vis other money market rates in an environment of declining yields. This appeared to be another example of the attraction that bond and equity mutual funds and other capital market instruments provided last year to investors. MMMFs grew in October and November, however, perhaps reflecting capital losses in bond funds

resulting from the rise in long-term rates in September and October.

The overall effect of the unusual forces that have been influencing M2 is summed up by the behavior of its velocity, which accelerated for the second year in a row, to a 3½ percent rate, despite the sharp downward trend in short-term interest rates over this period. Over previous decades, the velocity of M2 and short-term rates had moved together in a reasonably predictable way. This occurred because deposit rates lagged market rates. When, for example, short-term rates fell, deposit rates dropped by less, providing an incentive to shift assets from market instruments to deposits and depressing velocity. However, because of the unusual configuration of forces discussed above, these incentives to hold M2 have not followed their usual pattern in the current cycle. As noted, despite the drop in short-term interest rates, a combination of the steep yield curve, sluggish adjustment of loan rates, and other factors has *decreased*, not increased, the incentives to hold M2 in the last year. In other words, the opportunity cost—the earnings given up—in holding M2 actually has widened, rather than narrowed as has happened in the past when market interest rates fell, and this helps to explain why M2 velocity has risen atypically.

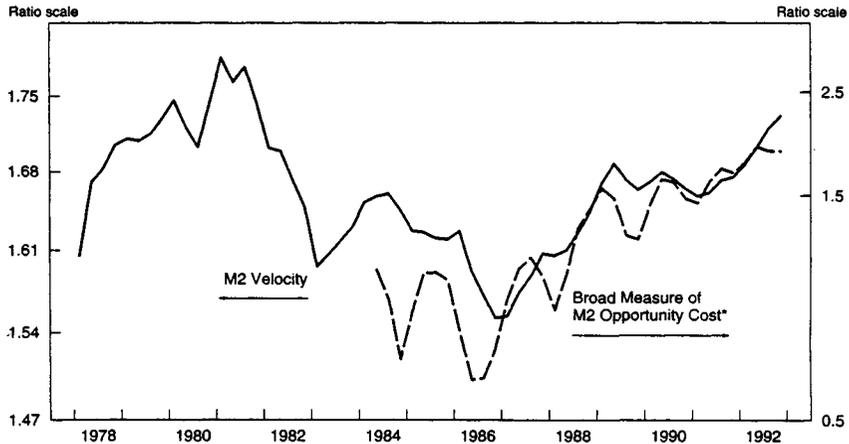
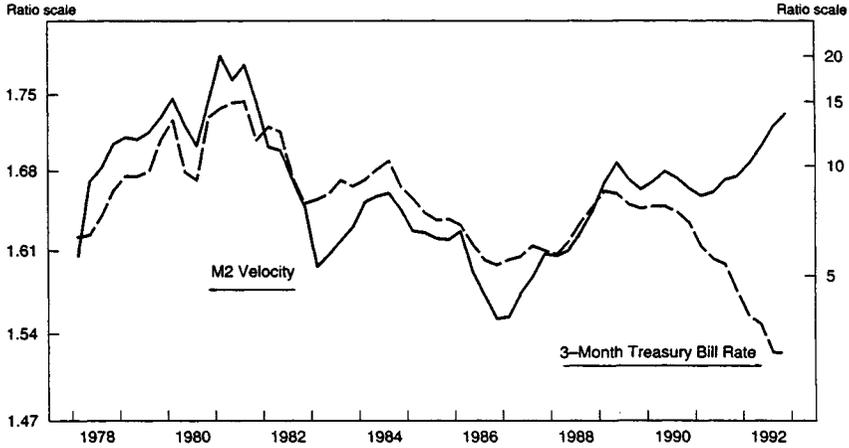
Another indication of the unusual behavior of velocity of M2 is the recent performance of the Board staff's P\* model in predicting inflation. This model is premised on the existence of a reasonably stable behavior of the velocity of M2 over time, and uses this to predict the price level and inflation rates, consistent with M2 growth. If the velocity of M2 is rising atypically, slow growth of M2 would not be associated with the degree of disinflationary pressures that would be predicted by the P\* model, which assumes normal velocity behavior. In fact, consistent with the notion that velocity is behaving abnormally, this model, using actual M2 growth, has underpredicted inflation in 1992.

The growth of M2 over the year was entirely attributable to its currency and transactions deposit components, as M1 growth surged to 14¼ percent in 1992. This performance reflected the advance in income growth, but mainly stemmed from declines in both short- and long-term interest rates. Long-term rate declines prompted large volumes of mortgage rate refinancings, particularly in the first and last quarters. Because a large portion of prepayments are held in demand deposits until the mortgage servicer remits the funds, the level of demand deposits is temporarily boosted by mortgage refinancings. Falling short-term

rates boosted demand deposits by lowering the opportunity cost of holding them and by increasing the amount of deposits businesses needed to hold under compensating balance arrangements. In addition, NOW accounts were boosted by funds shifted from

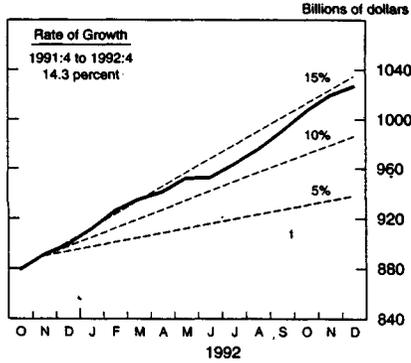
small time deposits, as rates on the latter fell faster than those offered on the former. Growth in NOW accounts last year accelerated from the already brisk pace of 1991, and demand deposits posted the largest increase since at least 1959.

**M2 Velocity and Measures of Opportunity Cost**



Note: Opportunity costs are two-quarter moving averages.  
 \*Estimated difference between a weighted average of competing rates (3-month T-bill, 5-year T-note, after-tax auto loan rate) and a weighted average of rates paid on M2 components.

## M1: Actual Growth



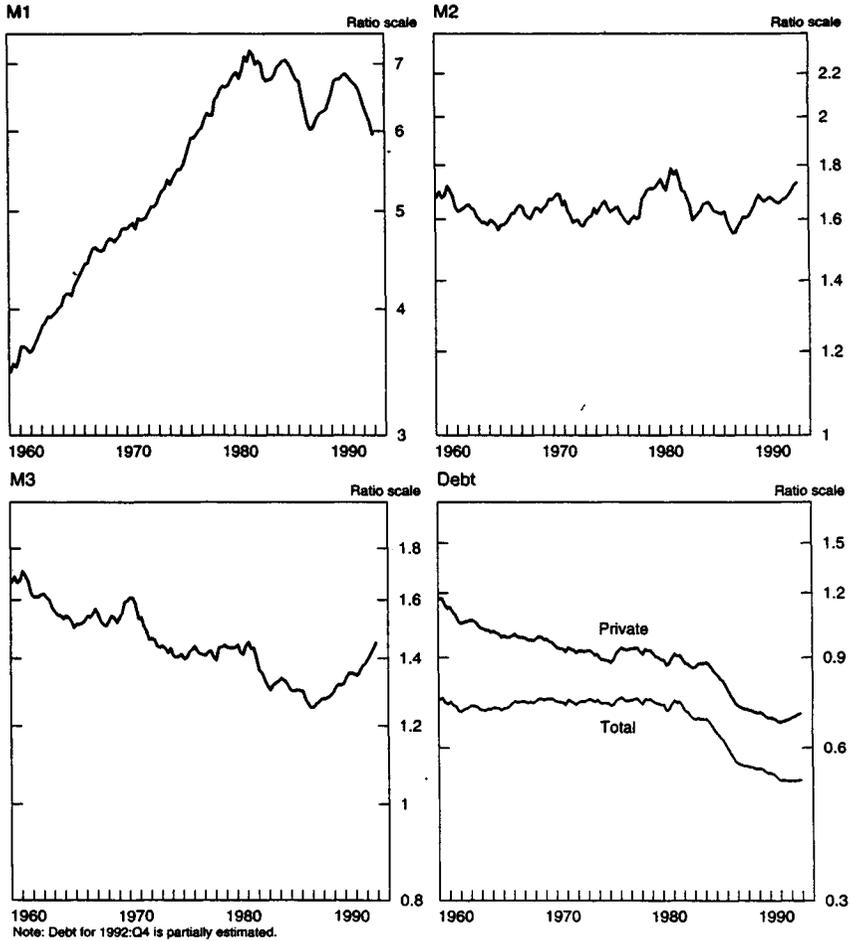
To accommodate the growth in transactions deposits associated with the process of easing reserve conditions, the Federal Reserve supplied large volumes of new reserves in 1992. Total reserves grew at around 20 percent, more than twice the rate of increase in 1991. Currency growth also was rapid, in part owing to shipments abroad, and as a consequence the monetary base increased 10½ percent last year—the highest growth rate in the Board's official series, which begins in 1959.

## Growth of Money and Debt (Percentage Change)

	M1	M2	M3	Debt of domestic nonfinancial sectors
<i>Fourth quarter to fourth quarter</i>				
1980	7.4	8.9	9.5	9.5
1981	5.4 (2.5)*	9.3	12.3	10.0
1982	8.8	9.1	9.9	9.3
1983	10.4	12.2	9.9	11.4
1984	5.5	8.1	10.8	14.3
1985	12.0	8.7	7.6	13.8
1986	15.5	9.3	8.9	14.0
1987	6.3	4.3	5.8	10.1
1988	4.3	5.3	6.4	9.2
1989	0.6	4.7	3.7	8.1
1990	4.3	4.0	1.8	6.9
1991	8.0	2.8	1.1	4.3
1992	14.3	1.9	0.5	4.6
<i>Quarterly (annual rates)</i>				
1992 Q1	15.5	3.3	2.0	4.3
Q2	10.6	0.6	-0.3	5.4
Q3	11.6	0.8	0.1	4.2
Q4	16.8	2.9	0.2	4.2

\*Figure in parentheses is adjusted for shifts to NOW accounts in 1981.

**Velocity of Money and Debt**  
Quarterly



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM  
WASHINGTON, D. C. 20551



ADDRESS OFFICIAL CORRESPONDENCE  
TO THE BOARD

Mr. William P. Albrecht  
Acting Chairman  
Commodity Futures Trading Commission  
2033 K Street, N.W.  
Washington, D.C. 20581

Dear Mr. Chairman:

Section 501 of the Futures Trading Practices Act of 1992 ("FTPA") amended section 2(a)(1)(B) of the Commodity Exchange Act to require any contract market in a stock index future contract (or option thereon) to file with the Board of Governors of the Federal Reserve System any rule establishing or changing the levels of margin (initial and maintenance) for these futures contracts or options. The Board may at any time request any contract market to set margin levels on these futures contracts or options at such levels as the Board, in its judgment, determines are appropriate to preserve the financial integrity of the contract market or its clearing system or to prevent systemic risk. If the contract market fails to do so within the time specified by the Board in its request, the Board may direct the contract market to alter or supplement the rules of the contract market as specified in the request. Subject to such conditions as the Board may determine, the Board may delegate any or all of its authority under this provision to the Commission.

The Board believes that levels of initial and maintenance margin set by contract markets generally are but one component of sophisticated risk control systems that may include frequent marking-to-market of customer and clearing member positions, participant criteria, standby liquidity arrangements, participant audits, market surveillance and active risk management, including the ability to raise levels of margins on short notice and to call for increased margin from specific customers or participants. Further, with the relatively rapid growth of stock index futures options at some contract markets, the determination of margins on such contracts has become an increasingly important issue.

The procedures for determining levels of margins on portfolios of stock index contracts are complex. The Board believes, furthermore, that the appropriateness of particular levels of initial and maintenance margin for meeting the criteria established by section 501 of the FTPA of preserving the financial integrity of contract markets or their clearing systems or preventing systemic risk can be evaluated only in the context of other credit and liquidity safeguards that are integral components of the overall risk control systems for these contract markets. Under section 5a of the Commodity Exchange Act, contract markets must submit rules, other than those relating to levels of margins, to the Commission for approval. Consequently, the Commission is both most familiar with the overall risk control systems of these contract markets and has the most comprehensive authority over these systems. This leads the Board to conclude that the Commission is the most appropriate entity to exercise the functions assigned to the Board under Section 501 of the FTPA.

Accordingly, under Section 2(a)(1)(B)(vi)(III) of the Commodity Exchange Act as added by Section 501 of the FTPA, the Board is hereby delegating its authority under Section 2(a)(1)(B)(vi)(I) and (II) of the Commodity Exchange Act to the Commodity Futures Trading Commission until further notice from the Board.

The Board would expect that, in reviewing such rules establishing or changing levels of margins (initial and maintenance) for stock index futures contracts (or options thereon), the Commission would consider the appropriateness of the margin levels in the context of the overall risk control system employed by the relevant exchange and its clearing system. Particular attention should be paid to the procedures used for determining margin levels on portfolios including futures options, and the ability of the exchange and its clearing system to cover any losses and meet financial obligations in a timely manner in the event of a default by a large participant. The Board expects the Commission to report to the Board annually on its experience in reviewing rules establishing or changing levels of initial and maintenance margins.

Very truly yours,

William W. Wiles  
Secretary of the Board

OIT/bbo  


67-884 (104)