CONDUCT OF MONETARY POLICY

Report of the Federal Reserve Board pursuant to the Full Employment and Balanced Growth Act of 1978
P.L. 95–523
and the State of the Economy

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL MONETARY POLICY

OF THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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CONDUCT OF MONETARY POLICY

WEDNESDAY, JULY 22, 1998

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC AND
INTERNATIONAL MONETARY POLICY,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Michael N. Castle, [chairman of the subcommittee], presiding.

Present: Chairman Castle; Representatives Lucas, Metcalf, Paul, Weldon, Roukema, Waters, Frank, Kennedy, C. Maloney of New York, Hinchey, Jackson, Watt and Lee.

Chairman CASTLE. The hearing will come to order, and we welcome you, Mr. Chairman, again, as we do twice a year.

We meet today to receive the annual midyear report of the Board of Governors of the Federal Reserve System on the Conduct of Monetary Policy and the State of the Economy, and, as you know, this is mandated in the Full Employment and Balanced Growth Act of 1978.

Mr. Chairman, we welcome you back to the House Committee on Banking and Financial Services and our Subcommittee on Domestic and International Monetary Policy.

The American economy continues to perform well, due in part to the work of the Federal Reserve. We are not greedy, but we would be very grateful if you can just announce that the current good economic times will continue for at least another 88 months.

Let me just say this: Sometimes when I give graduation speeches, I tell a little story about a man standing on a plain giving a speech, and he sees a speck in the horizon, and he doesn't know what it is. And then after a couple of minutes the speck grows, and then he realizes it is a herd of buffalo. And then he realizes the herd of buffalo is getting closer, and he can distinguish what they are, and he also realizes if he is not through his speech in ten minutes, that he is going to be overrun by the buffalo. With the idea that I will speak for ten minutes—I will now cut that to eight minutes by the way. The kids didn't even like the ten minutes, I learned.

But I feel the same way about Asia and with respect to what I would like to personally extract from this hearing today, and I realize it is very important in your case to make prepared statements, but it terms of our questions and answers, we need to address those particular questions.

I feel that Asian economic problems came upon us unexpectedly. I don't think we were prepared for it at any segment of the American economy all the way from intelligence to the Government to the private sector. I think it has been more extensive in terms of involving countries than perhaps originally anticipated. I think the longevity of it has extended at least as long as anybody has said, and perhaps longer. And, of course, the threat of it with respect to Japan is perhaps greater than we ever expected.

I think the counterpoint to all this, and some of this is set forth, I have a story from *U.S. News and World Report*, "Will Japan Trip the Bull?", the highlights that you talked about, half your testimony before the Senate yesterday. But a good portion of what has happened so far has actually, in my judgment, been beneficial to the American economy in terms of reduced prices for commodities, for oil, for finished products, in terms of capital coming into the United States to avoid problems in other countries. And, yes, there have been some slowdowns on some orders and maybe hitting particular segments of our economy, but for the most part you can almost make an argument as good for positive as has been negative. And yet I have that feeling that we are getting to a precipice at which point it is going to become quite negative rather rapidly, and are we ready for that? Do we really anticipate where that is going?

When you visited us in February of this year, we discussed our concern over the troubled Japanese economy. The change in the Government of Japan has confirmed, in my judgment, that those concerns were valid. The Asian economic uncertainty, and especially the status of Japan's economy, I believe, are almost certainly the greatest threat to our own economic health. That is a personal judgment; you haven't stated that. More than inflation or any domestic problem we have, I think that is by far the greatest threat to our own economic health, and I hope that you will share with us today through the question and answer period, as well as your speech, your impressions regarding the degree of seriousness with which the Japanese authorities are approaching the solution of their economic problems.

The rest of Asia is still, at best, digging out of their own problems. Maybe their problems are even worsening, and success, in my judgment, depends heavily on Japan.

The danger of spreading this international economic flu seems even more real when we watch the situation in Russia. If oil prices continue to hover around the current low levels, Mexico may again be in crisis, and others in Latin America could follow, so I hope you will comment on the dangers of the regional economic problems reinforcing each other, what they may mean for the world economy.

As you know, the debate continues to rage right here in Congress almost daily this week, as a matter of fact, over whether the United States should contribute an additional $18 billion to the International Monetary Fund to help meet international economic instability, and I am very eager to hear your views on the role of IMF in addressing these problems.

While we look to you to alert us to what we should be worrying about, we also expect that when you address the House, the markets will move up, as opposed to occasions when you address the

Senate, a trend noticed in recent hearings before the House and the Senate.

The high relative value of the dollar evidently continues to reflect both the leading position of our economy with regard to Europe, the Far East, and the capital that arrives from areas suffering economic insecurity. Should we anticipate further action such as the June 17 intervention to prop up the yen? As a general rule is this an effective strategy?

As the economy continues to rewrite the traditional models, we welcome your insight regarding adjustments being incorporated into your models.

My view is that we must have a full discussion of the potential impact of events in Japan and Asia on the future of our own economy and working Americans, and what steps we as policymakers can take to protect our Nation.

As always, we are delighted to have you with us, and we look forward today to a lively discussion.

[The prepared statement of Hon. Michael N. Castle can be found on page 46 in the appendix.]

Chairman CASTLE. And with that, let me turn to Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

I find today's hearing a little different than usual because I think for the first time in my memory we do not meet under what I consider to be the imminent threat of a rate increase being rattled by some of the Chairman's tellings. But I really wanted to talk about, because I think we have a little breathing space now, the overall situation.

I noted, Mr. Chairman, that you mentioned yesterday and mention again today the danger of inflation, and we have had this conversation before. You do, when asked, acknowledge that there is a concern both about excessive growth and about inadequate growth. But it does seem to me, reading your statements, certainly the emphasis, clearly the thrust, is much more to be concerned with inflation.

Now, that is partly institutional, obviously, and I understand that you are not, despite what some people say, a one-person board. We recognize that you serve with a number of other appointees and regional bank presidents, and that there is more collegiality, in fact, than journalistic shorthand sometimes suggests, and I understand those concerns that you have to deal with. But what this comes up with is institutionally a Federal Reserve, which is, it seems to me—there is a bias from time to time that you vote. You voted that there is a kind of a predisposition to raise interest rates. It seems to me that is almost superfluous for you to vote it because institutionally the Federal Reserve system is clearly more worried about that.

The problem is that the way things have evolved, the Federal Reserve has become, by far, the most potent economic policymaker in the country. So what we have is a disproportion here. There is no entity concerned about banking growths that has the ability to move events, the policy impact and the role that the Federal Reserve has.

Now, I am very pleased that since March of last year, and that was a fairly minor exception, the Federal Reserve has maintained what seems to be an appropriate posture, and I understand that that could not always, for everybody at the Federal Reserve, be an automatic decision. So I am pleased at the way policy has gone, but I think we continue to have this problem.

I look at America today. I look at the social problems we still have, the potential growth in inequity, and that is the real problem.

You know, I have a very odd district. I have a district that the Massachusetts Legislature was particularly whimsical when they drew up. They weren't really specifically concerned with me. The Governor was trying to hurt one guy, the senate president was trying to help another guy. I got what one didn't want and the other one wanted. One guy didn't get what he didn't want, and one guy didn't get what he wanted, and I got the remains. I have a district which, in consequence, if I were African American, would be found to be unconstitutional. Only white people under current jurisprudence may be the beneficiaries of gerrymandering as blatant as happened in Massachusetts in 1992, but it gives me a very interesting look.

I have a northern part of my district which is very much benefiting from the world economy, people who work at Fidelity, people who provide first-rate medical care, people who develop higher technological and software products. And I have, in the southern part of my district, people who have worked very hard all their lives in traditional manufacturing for whom global integration has not on the whole been a good thing, and they have on the whole lost out.

One of the problems we have is that not surprisingly, the children of the people who live in the north overwhelmingly live in homes where there are computers and people to teach them how to use them; and overwhelmingly people in the south—not overwhelmingly, but the majority of people in the south do not have that.

Whatever one thinks about current problems, not to resolve those problems is to guarantee a worsening of inequity with consequent negative problems to the society, and I worry that we do not have institutionally any entity that is prepared to take that on and that there is a kind of a bias.

And finally let me say, if I just may be 30 seconds over, Mr. Chairman, but I was thinking about Harry Truman the other day and Harry Truman's famous comment that what he wanted was a "one-handed economist," because he wouldn't be saying, "... on the one hand" and "... on the other hand." I would like an economist whose hands are untied.

What I have found recently is that economists on the whole, and that includes the economists at the Federal Reserve, a very distinguished aggregation, probably the world's most powerful economists are collected at the Federal Reserve in terms of the impact they collectively have on public policy. And there is a distrust of politicians. There is a tendency to filter what you tell us because you are afraid, I think, that if we are told things unvarnished, we may react irresponsibly.

For example, when we talk about trade, I have had economists privately acknowledge to me that, yes, there are negative effects to trade as well as positive effects, but they believe that the positive effects greatly outweigh the negative effects, and they are afraid that acknowledging the negative effects, that we politicians overuse them.

Similarly I have a sense that the economic dues with regard to the inflation on employment tradeoff and the fact that there is not nearly as much of a tradeoff as we thought, I think many economists in their heart of hearts know that things have gotten better, but are afraid to tell us because they are afraid of populistic viewpoints. They are afraid that if we learn what was happening, we might kind of slip the traces.

And the thing I want to stress again in closing, and I appreciate the indulgence, Mr. Chairman, is even from their own standpoint, they are underestimating the importance of equity. Even as we sit here today, you and I, Mr. Chairman, and I think my colleagues who happen to be here today, most of us are strong supporters of an appropriately worded IMF increase, but we have trouble getting the votes. Until and unless—and this is the final point I wanted to make—until and unless we as a society do a better job of addressing equity issues and particularly reassuring people that globalization is not going to come at the expense of the least educated and the least equipped to compete in the world, we are going to have a resistance to what you see as our rational self-interest regarding international economics, and I worry, just to tie this together, that the institutional trigger finger itchiness about interest rate raising at the Federal Reserve is a constraining factor on that.

Thank you for your indulgence, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Frank.

Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman. I will abbreviate my remarks, having heard the extension of your remarks. But I do want to welcome Chairman Greenspan here today. I believe that he and the Federal Reserve should be congratulated on their wise conduct of monetary policy. I have no question that it has had positive effects in terms of sustaining a very healthy economy. I certainly look forward to what your analysis is today. I believe that you have shown not only incisive actions, but also clearly articulated your approach to both national and international economic issues.

Certainly one important issue, most immediate to all of us, and I will be interested in your additional comments, is IMF funding. You and I have always agreed on IMF funding. It is an immediate issue this week. I am hopeful that we cannot only get the $3.5 billion, but that we will ultimately get the full amount. I would like to work with you on that and hope that you address this issue with precision in your statement today.

I certainly understand and want to work with my Republican colleagues in terms of bringing some reforms to the IMF so it is consistent with what we did in the committee in terms of the question of transparency and conditionality and maybe go farther, but I would hope that this would be an opportunity for you to stress the importance of IMF funding and provide your insights on this issue.

I did hear the Chairman's references to the Asian crisis, and specifically to the Japanese banking question. I won't go into that again, but I do want to say that I hope you will be precise in addressing the question of the so-called U.S. budget surpluses and the whole question of tax reductions, whether or not they are appropriate and to what degree they are appropriate now in the context of our total economy, monetary policy and the budgetary questions.

So I am actively looking forward to hearing what you have to say. You are a true patriot as well as a leader in the world economic situation, particularly our own healthy economy, and hopefully with your leadership we can continue that and spread it to Southeast Asia as well.

Thank you, Mr. Chairman. Thank you.

Chairman CASTLE. Thank you Mrs. Roukema, and thank you for abbreviating your statement somewhat. We hope that others perhaps can follow so we can get to the Chairman as soon as possible.

With that let me turn to Mr. Hinchey.

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

Welcome, Mr. Greenspan. Pleasure to see you again. I look forward to your testimony, although some of us had an opportunity to see it on C-SPAN last night. I assume that things haven't changed all that much in the intervening 24 hours.

The availability of the minutes of the Federal Open Market Committee, even though there is a lag, continue to demonstrate their value. Among other things, they have shown us that there has been some disagreement among the members of the FOMC with regard to monetary policy. And in that regard I want to express my personal appreciation to the leadership that you have shown in resisting what at least a couple of the bankers on the committee would have done if they had had their way, they would have increased interest rates, and I think that that would have been a very serious mistake.

There are those of us who believe that real interest rates, interest rates as a function of inflation, continue to be too high. I am particularly concerned about our readiness to deal with certain economic circumstances that have begun to express themselves in some cases rather dramatically and other cases less so. Inflation remains very, very low indeed. The latest indicators show that over the course of the last year, June to June, consumer prices and producer prices have gone up less than 2 percent. So inflation remains very, very low.

We have the Asian crisis, which is now beginning to express itself more fully, and hear at home, the trade deficit is reaching enormous proportions. The Asian crisis is principally responsible for the growing trade deficit, though the strong dollar is also playing a role in it.

There is also the strike at General Motors, as well as an apparent loss in manufacturing jobs. Current figures show manufacturing jobs dropping off in the most recent reporting period. Those, coupled with a number of other factors which seem to indicate that the economy is slowing, cause me to be concerned that we are not doing all that we can to prepare ourselves for the full impact of all these economic circumstances.

So, I expect that you will address these issues as you did yesterday to some extent before the Senate Banking Committee, and I would continue to hope that the Open Market Committee and Federal Reserve generally would express a more deep and accurate realization of the impacts of the Asian crisis because I feel that we are not preparing ourselves adequately for the consequences. All the forecasts indicate that we are going to see a downturn in our economy, and it may be that we can do things that will make it less serious. I hope that you will address your remarks to that as well.

I thank you very much.

Chairman CASTLE. Thank you.

The Chairman of the full Banking Committee, Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman. I will be brief, but I think it appropriate to reference when the economic circumstances that are so positive have occurred. I think you will go down as the most thoughtful and successful Federal Reserve Chairman in the country. Having said that, though, I think it should not be lost on anyone that the most important phenomenon of monetary policy is not necessarily the individual stewardship of an exceptional Chairman, but is the independence of the Fed itself. And for those of us in the Legislative branch, it is important that we realize and recognize that. In fact, it is not inconceivable that when people write the economic history of the 20th century, the judgment might not be that the most important institution of governance was established in this century was the Federal Reserve Board of the United States, and that it has been the most successful. And we, in that context, welcome this distinguished Chairman.

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

I will turn next—I think Mr. Bentsen was the next to arrive. No statement?

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. I will be very brief. I certainly won't take the five minutes.

I just wanted to welcome the Chairman to the subcommittee and express my thanks to him for his recent appearance in Charlotte where he was an outstanding success and drew a record crowd to his comments there.

I resisted the temptation to stop and listen to your comments on C-Span last night so that I could hear them fresh today, and I am looking forward to hearing them. I hope that you will specifically comment on one concern that I have and certainly not professing to be an expert in this area, but there is a clear interplay between unemployment and interest rates and inflation, as you see it, and unemployment in the aggregate clearly has been very low, but in some parts of our communities, inner cities in particular, unemployment continues to be in double digits. And so I hope you will address your approach to deciding when to raise interest rates, taking that into account, the global aggregate unemployment picture, but also how we address the issue of unemployment in some of the higher unemployment areas in the context of that overall picture. And if you will address that issue at some point during your stay here, I would be most appreciative.

Thank you Mr. Chairman. I yield back.

Chairman CASTLE. Thank you Mr. Watt.

Mr. Paul. Thank you.

Mr. Bachus.

Mr. BACHUS. Thank you. I am not going to make a statement at this time.

Chairman CASTLE. Thank you.

Mr. Kennedy.

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

Welcome again, Chairman Greenspan. Just a brief statement, Mr. Chairman.

First of all, after reading today's papers and hearing of your testimony yesterday on the Senate side, I am concerned that we are in the midst of a dilemma where, when it comes to the major overriding concern of the U.S. economy, we talk about the threat of inflation, which seems driven by the idea that somehow there is an unemployment number that threatens to create increased prices, and I worry that we essentially put the poorest of the poor in an untenable position.

And I recognize, as I have heard you testify many times before, that this is an issue that you care about, but it is not an issue that the Fed has direct control over; but it is, on the other hand, an issue that I think needs to be brought out, and that it is helpful to have you acknowledge, Mr. Chairman, in the sense that if, as the statistics that I have seen demonstrate, that the City of Philadelphia has to create by year's end 54,000 jobs for people on welfare, the City of Chicago, 164,000 jobs, the City of Boston has to create almost 3,000 jobs a month just to get the people that are going to lose their welfare benefits the work that they need or else people are going to be thrown out.

We cut the housing budget, and yet what happens is when the economy of the country rises to a point where we then say now there is an inflation threat, then you are put in a position where you and evidently, as I understand, other members of the committee then put a great deal of pressure on the committee in general, and you in particular, to raise interest rates, therefore cutting off the very stepladder that these individuals need in order to get a job, and just when the companies are feeling some pressure to actually reach down into the pool of workers that don't have the job skills that they really need and give the kind of job training that these folks have to have in order to get a decent job, we then say, "Oh, sorry, gang." I guess the overall economy is going to be threatened, so therefore we are going to raise inflation, so therefore we are going to cut off the ability of these people to ever get out, thereby creating this sort of perpetual hamster-like treadmill of economic life for the very poor.

I just think, Mr. Chairman, you know the power that you have or have a sense of the power that you have in terms of how many people listen to you because of the phenomenal record of success that has occurred in our country since you have been Chairman of the Fed, which is really astounding. I mean, the economy has worked at a phenomenal rate, and it is something that you should take great pride in. But I think that I just want to point out that while we have this economy that is roaring along for the vast majority of Americans, and that is terrific, there is a whole group of Americans that is just getting left behind, and we are doing very little to address those needs and those concerns.

So, I would hope that you would take some time to talk about what we ought to be doing in order to make certain that everybody is allowed to participate to grow to their full potential.

Thank you.

Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Kennedy, and I yield to the Ranking Member of the subcommittee Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman. First I would like unanimous consent to enter into the record the statement of David A. Smith, Director of Public Policy for AFL-CIO.

Chairman CASTLE. Without objection, submitted.

[The prepared statement of David A. Smith can be found on page 115 in the appendix.]

Ms. WATERS. I have an opening statement that I would like to present, Mr. Chairman.

I would like to welcome my friend Chairman Greenspan here today for the second of our yearly Humphrey-Hawkins hearings on the Federal Reserve's monetary policy.

We must not forget that while the Humphrey-Hawkins Act set up a system for monitoring the formulation of monetary policy by the Federal Reserve, it also states that a goal of Federal Government economic policy includes the importance of job creation and the maximization of employment for our Nation's citizens.

I look forward to the opportunity to hear from you, Chairman Greenspan, in your assessment of the current state of the economy. Press reports indicate that while you praised our robust economy, you did express concerns that if the U.S. economic growth did not slow down, the danger of inflation was real. While I understand the fears of some that current economic conditions are unsustainable without creating inflationary pressures, I encourage you, of course, to refrain from any monetary policy changes that would threaten the much needed growth of our economy and the positive effect on our poorest communities.

I question whether the numbers present any indication of such a trend. Unemployment rates, currently at 4.5 percent nationwide, have remained at an historic low for more than a year. At the same time inflation has remained low most recently at nearly zero percent. There are also some signs that the economy may be slowing as a result of the continued Asian economic crisis. Recent statistics show the growth rate leveling off as well as an increase in the stocks of unsold goods resulting from decreased demand for our domestic goods. We have already seen the nationwide unemployment rate increase from 4.3 percent in April and May to 4.5 percent in June.

Additionally, as we review the economic indicators and their implications for monetary policy, I hope that we remain cognizant of the fact that these indicators, while encouraging, do not tell the entire story. Unfortunately many of these statistics do not paint an accurate picture of the economic conditions across all communities and populations. For example, while the overall unemployment for the Nation is 4.5 percent, in California it is 5.7 percent, and in the Los Angeles/Long Beach recent statistics, we see that the unemployment rate is 6.1 percent.

If you look at the unemployment numbers by ethnicity, the disparity is even greater. African Americans as a group have an unemployment rate of 8.2 percent nationwide, more than twice that of the white population. Those with less than a high school diploma have an unemployment rate of 7.2 percent compared to 1.7 percent for college graduates.

My seven other Members of this committee represent many of those Americans whose success depends on an expanding economy which can reach down and include the more marginalized sectors of our country in the economy. Lower unemployment rates create employment opportunities for some sectors of our society who do not currently participate in the formal economy. Unfortunately those in the poor and the lower middle classes tend to be impacted most severely by the dampening effect of increased interest rates. Chairman Greenspan has witnessed firsthand during a trip he made to south central Los Angeles earlier this year the continued economic disenfranchisement of many of our poor and inner-city communities.

I see the economic boom we are experiencing as giving a wonderful opportunity to grow all sectors of our economy and all of our communities. Any calculation of needed changes to monetary policy through an increase in rates must include this goal.

I look forward to engaging in a dialogue with you, Mr. Chairman, on these critical issues, and I thank you for being here this morning.

Chairman CASTLE. Thank you Ms. Waters.

Dr. Weldon, you have just arrived. We are still doing brief opening statements if you wish to make one.

Dr. WELDON. I came to hear Mr. Greenspan and not myself. Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, sir.

Mr. Jackson.

Mr. JACKSON. Just unanimous consent, Mr. Chairman, to enter my opening remarks in the record, sir.

Chairman CASTLE. Certainly. Without objection they are so entered.

Mr. JACKSON. Thank you.

Chairman CASTLE. Ms. Lee.

Ms. LEE. Thank you Mr. Chairman.

Let me just extend my welcome to you, Chairman Greenspan, and indicate to you that I am one of the newest Members to the Banking Committee and the newest Member to the subcommittee. However, the subject of today's hearing is not new to me. Of course, I was here during the time when the Humphrey-Hawkins bill was being debated in 1978. Also, as we know, the first Full Employment Act passed in 1946 is known as the Roosevelt-Truman Full Employment Act. And my predecessor, Congressman Dellums, actually introduced the first Full Employment Act bill here recently, H.R. 1050, in the 1993 session, 103rd session of Congress, and it is also known as the Living Jobs for All Act.

As a member of the California Assembly and Senate, I introduced parallel bills to H.R. 1050, and I mention this because of the fact that all of these efforts to achieve full employment are efforts that are part of our history, but also today I am very interested in hearing your testimony with regard to the issues that involve what actually constitutes full employment in our country.

Thank you very much for this opportunity to meet you actually, and I look forward to this hearing.

Chairman CASTLE. Thank you, Ms. Lee.

Ms. Kilpatrick, did you wish to say anything at the opening?

Ms. KILPATRICK. Just briefly, Mr. Chairman, thank you very much, and to Mr. Greenspan, I appreciate your coming and look forward to listening to your remarks. I did hear yesterday and read some of your remarks.

The General Motors strike, General Motors is in my district, and, as you know, the number one corporation in the world. It does not look like it will be ending soon, although things can change as we speak. The impact of the strike, the unemployment that it will cause, as you probably know, Ford and Chrysler farm out much of their parts. General Motors has parts plants and employ over 150,000 people in those plants, which is the sticking issue in that strike. What impact, if any, will that have, and has it yet begin to spill over in the economy? I will be interested in hearing your remarks.

Thank you for coming. Look forward to hearing you.

Chairman CASTLE. Thank you, Ms. Kilpatrick.

I think we have given everybody an opportunity who wanted to say something to say something, and we now look forward to your statement, Mr. Chairman. You have heard the concerns of many of the Members, and we look forward to your statement and then a lively discussion and the question and answer period to follow.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I have a rather extended prepared set of remarks and request that my excerpted version be included in the record, along with the full text.

Chairman CASTLE. Certainly. Both would be included in your comments. Thank you, sir.

Mr. GREENSPAN. Mr. Chairman and Members of the subcommittee, when I appeared before you in February, I noted that a key question for monetary policy was whether the consequences of the turmoil in Asia would be sufficient to check inflationary tendencies that might otherwise result from the strength of domestic spending and tightening labor markets. In the event, the contraction of output and incomes in a number of Asian economies has turned out to be more substantial than most had anticipated. Nonetheless, the American economy proved to be unexpectedly robust in the first quarter.

Evidently, optimism about jobs, incomes and profits, high and rising wealth-to-income ratios, low financing costs, and falling prices for high-tech goods fed the appetites of households and businesses for consumer durables and capital equipment. In addition, *inventory investment contributed significantly to growth in the* first quarter.

Although national income and product account data for the second quarter have not yet been published, growth of U.S. output appears to have slowed sharply, owing primarily to a further deterioration in our trade balance and a slowing pace of inventory investment. Indeed readings on the elements that make up the real GDP have led many analysts to anticipate a decline in that measure in the second quarter after the first-quarter surge.

It is worth noting that other indicators of output, including worker hours and manufacturing production, show a somewhat steadier, though slowing, pace over the first half of the year. And underlying trends in domestic final demand have remained strong, imparting impetus to the continuing economic expansion.

Inflation has stayed remarkably damped. The Consumer Price Index as well as broader measures of prices indicate that inflation moved down further during the first quarter, even as the economy strengthened. The more recent price data suggest that overall consumer price inflation moved up in the second quarter, but even so, the increase remained moderate.

So far this year, our economy has continued to enjoy a virtuous cycle. Evidence of accelerated productivity has been bolstering expectations of future corporate earnings, thereby fueling still further increases in equity values, and the improvements in productivity have been helping to reduce inflation. In the context of subdued price increases and generally supportive credit conditions, rising equity values have provided impetus to spending and, in turn, the expansion of output, employment, and productivity-enhancing capital investment.

The essential precondition for the emergence and persistence of this virtuous cycle is arguably the decline in the rate of inflation to near price stability. In recent years continued low product price inflation and expectations that it will persist have promoted stability in financial markets and fostered perceptions that the degree of risk in the financial outlook has been moving ever lower. These perceptions in turn have reduced the extra compensation that investors require for making loans to, or taking ownership positions in, private firms.

To a considerable extent investors seem to be expecting that low inflation and stronger productivity growth will allow the extraordinary growth of profits to be extended into the distant future. Indeed, expectations of earnings growth over the longer term have been undergoing continual upward revision by security analysts since early 1995. These rising expectations have, in turn, driven stock prices sharply higher and credit spreads lower, perhaps in both cases to levels that will be difficult to sustain unless the virtuous cycle continues.

Probably only a few percent of the largely unrealized capital gains have been transformed into the purchase of goods and services in consumer markets, but that increment to spending, combined with the sharp increase in equipment investment, which has stemmed from the low cost of both equity and debt relative to expected profits on capital, has been instrumental in propelling the economy forward.

The consequences for the American worker have been dramatic and for the most part highly favorable. A great many chronically underemployed people have been given the opportunity to work, and many others have been able to upgrade their skills.

Government finances have been enhanced as well. In the Federal sector the taxes paid on huge realized capital gains and other incomes related to stock market advances, coupled with taxes on markedly higher corporate profits, have joined with restraint on spending to produce a unified budget surplus for the first time in nearly three decades.

The fact that economic performance has strengthened as inflation subsided should not have been surprising, given that risk premiums and economic disincentives to invest in productive capital diminish as the economy approaches price stability. But the extent to which strong growth and high labor force utilization have been joined with low inflation over an extended period is, nevertheless, exceptional.

For one thing, increases in hourly compensation have been slower to pick up than in most other recent expansions, although, to be sure, wages have started to accelerate in the past couple of years as the labor market has become progressively tighter. For another, a couple of years ago, almost at the same time that increases in total hourly compensation began trending up in nominal terms, evidence of a long-awaited pickup in the growth of labor productivity began to show through more strongly in the data: this accelerated increase in output per hour has enabled firms to raise workers' real wages while holding the line on price increases.

Notwithstanding a reasonably optimistic interpretation of the recent productivity numbers, it would not be prudent to assume that even strongly rising productivity, by itself, can ensure a non-inflationary future. Certainly wage increases per se, are not inflationary unless they exceed productivity growth, thereby creating pressures for inflationary price increases that can eventually undermine economic growth and employment. Because the level of productivity is tied to an important degree to the stock of capital, which turns over only gradually, increases in the trend growth of productivity probably also occur rather gradually. By contrast, the potential for abrupt acceleration of nominal hourly compensation is surely greater.

As I have noted in previous appearances before Congress, employment growth has been significantly outstripping expansion of the working-age population. This gap will inevitably close. What is crucial to sustaining this unprecedented period of prosperity is that it close reasonably promptly, given already stretched labor resources, and that labor markets find a balance consistent with sustained growth marked by compensation gains in line with productivity advances. Whether these adjustments will occur without monetary policy action remains an open question.

While the United States has been benefiting from a virtuous economic cycle, a number of other economies unfortunately have been spiraling in quite the opposite direction. The United States, Canada and Western Europe have been enjoying solid economic growth, with relatively low inflation and declining unemployment, but the economic performance in many developing and transition nations and Japan has been deteriorating. How quickly the latter erosion is arrested and reversed will be a key factor in shaping U.S. economic trends in the year ahead.

In the current circumstances, we need to be aware that monetary policy tightening actions in the United States could have outsized effects on very sensitive financial markets in Asia, a development that could have substantial adverse repercussions on U.S. financial markets and, over time, our own economy. But while we must take account of such foreign interactions, we must be careful that our responses ultimately are consistent with a monetary policy aimed at optimal performance of the U.S. economy. Our objectives relate to domestic economic performance, and price stability and maximum sustainable economic growth here at home would best serve the long-term interests of troubled financial markets and economies abroad.

Although external economic conditions have deteriorated, some of the key factors that have supported strong final demand by domestic purchasers here remain favorable. With their incomes and wealth having been on a strong upward track, American consumers remain quite upbeat. For businesses, decreasing costs of and high rates of return on investment, as well as the scarcity of labor, could keep capital spending elevated. These factors suggest some risk that the labor market could get even tighter, and even if it does not, under prevailing tight labor markets, increasingly confident workers might place gradually escalating pressures on wages and costs, which would eventually feed through to prices.

But a number of factors likely will serve to damp growth in aggregate demand, helping to foster a reasonably smooth transition to a more sustainable rate of growth and reasonable balance in labor markets. We have yet to see the full effects of the crisis in East Asia on U.S. employment and income. Residential and business fixed investment already have reached such high levels that further gains approaching those experienced recently would imply very rapid growth of stocks of housing and plant and equipment relative to income trends.

Inflation performance will be affected by developments abroad as well as those here at home. The extent and pace of recovery of Asian economies currently experiencing a severe downturn will have important implications for prices of energy and other commodities, the strength of the dollar, and competitive conditions on world product markets.

On a more fundamental level, it is the balance of supply and demand in labor and product markets in the United States that will have the greatest effect on inflation rates here. As I noted previously, wage and benefit costs have been remarkably subdued in the current expansion. Nonetheless, an accelerating trend in wages has been apparent for some time. In addition, a gradual upward tilt in benefit costs has become evident of late.

Given that compensation costs are likely to accelerate at least a little further, productivity trends and profit margins will be key to determining price performance in the period ahead. We at the Fed will be closely monitoring a variety of indicators to assess the degree to which productivity is on a stronger long-run track after what is likely to appear in the data as a weak second quarter.

Significant risks attend the outlook. One is that the impending constraint from domestic labor markets could bind more abruptly than it has to date, intensifying inflation pressures. The other is the potential for further adverse developments abroad, which could reduce the demand for U.S. goods and services more sharply than anticipated, and which would thereby ease pressures on labor markets. While we expect that the situation will develop relatively smoothly, we believe that given the current tightness in labor markets, the potential for accelerating inflation is probably greater than the risk of protracted, excessive weakness in the economy.

As I have stated in previous testimony, Mr. Chairman, the recent economic performance, with its combination of strong growth and low inflation, is as impressive as any I have witnessed in my near half-century of daily observations of the American economy. Although the reasons for this development are complex, our success can be attributed in part to sound economic policy. The Congress and the Administration have successfully balanced the budget, and indeed, achieved a near-term surplus, a development that tends to boost national saving and investment. The Federal Reserve has pursued monetary conditions consistent with maximum sustainable long-run growth by seeking price stability. These policies have helped bring about a healthy macroeconomic environment for productivity-boosting investment and innovation, factors that have lifted standards of living for most Americans. The task before us is to maintain disciplined economic policies and thereby contribute to maintaining and extending these gains in the years ahead.

Thank you very much. I look forward to your questions.

[The prepared statement of Hon. Alan Greenspan can be found on page 49 in the appendix.]

Chairman CASTLE. Thank you, Mr. Chairman.

I yield first to myself for five minutes of questions, and I would like to go back to my opening statement and what probably was involved in at least a third of your testimony, which is a lot different than probably would have been a year or two ago, and that is the Asian crisis which just a year ago was just getting under way.

I like to try to be a little more precise in some of the things we are trying to determine here. Have we seen the end of it? If not, and I assume the answer is probably going to be no, how do you see it playing out? And is it likely to spread to Latin America; help with the problems or add to the problems in Russia, for example?

I indicated in my statement that I think if anything, you can almost argue that if you weigh the pluses and minuses, it has actually benefited the American economy more than hurt it because of the flight of capital and cost reasons and other reasons. But what are its likely future effects? And I am sure that you almost sit there and model this stuff on a regular basis in terms of the most drastic-type things that can happen, but I am more interested in what everyone views as the most likely scenario. It seems to me that this has been quite poorly predicted so far, I mean, at least in terms of the extent of it in many ways. So I am concerned about the future. I don't expect you to have precise answers because we are talking about unfolding developments, but I would like to hear your response to some of those points.

Mr. GREENSPAN. I agree with your comments, Mr. Chairman. First of all, let me just say that the evidence we have to date as yet shows no evidence of stabilization and that the most recent data still exhibit deterioration. The question of most fundamental importance to all of us, obviously, is how long will that continue, and where will it spread, and to what extent will the stampede of buffalo, as you implied, stomp over us before we can stem it.

You point out quite correctly that the crisis was not forecast in any meaningful way by really the vast majority of analysts, and indeed I know of no one who really did say at the point when the crisis was emerging that it was about to occur. That tells us something very important about the nature of the process itself.

As I have indicated in other testimony, what we have is a situation in which you can build up imbalances in an economy which may or may not induce significant erosion or major contraction, but periodically these buildings up of imbalances are like water backing up against a dam. Most of the time they are held by the dam, but every once in awhile the dam cracks, and you get a huge rush.

It is a vicious cycle indeed, precisely the opposite of the virtuous cycle that we have seen in the United States. You get an implosion of confidence in which pessimism feeds on pessimism. Everyone withdraws from activities related to an economy. Trust, which is crucial to any particular social organization, especially an economy, falls, and the situation feeds on itself in a downward spiral.

It is very difficult to forecast where that eventually stabilizes or how it comes out, but this clearly is the process which we have seen which is by its nature almost impossible to forecast. We can stipulate the conditions which are probably necessary for such an event occurring, but rarely, if ever, the sufficient conditions to do that.

I would say at this particular time that we do not know at what point this will turn. It will depend to a very substantial extent on the restoration of confidence, and the restoration of confidence will depend on the types of economic policies that these countries are involved with.

Chairman CASTLE. Thank you, Mr. Chairman.

I am going to ask you one different question. I would love to pursue that line, but as you know, we have a limited time, so I am going to change subjects altogether because I am interested in another answer.

You have previously suggested that reducing the Federal budget deficit was a high-priority item, and I agree with that, and because of this issue, you have urged Congress to defer cutting taxes. Would the prospect now before us of a large and growing budget surplus this year and in future years, do you now feel that this may be an appropriate time for a tax cut?

Mr. GREENSPAN. Mr. Chairman, it is really quite a pleasant event to have this type of problem confronting us as distinct from the problem of how do you bring a chronic budget deficit down. So it is an issue of good choices rather than bad choices.

Let me just first say before we even contemplate what is done with this extraordinary surplus, which is being projected into the indefinite future, that we have not been able to forecast with great accuracy where the budget balance ends up, as the history of recent years has amply demonstrated. There is no doubt that the very sharp increase in stock market values and the whole huge increase in market wealth, which has occurred both in households and in businesses in this country, is spilling over into various types of capital gains and incomes coming from stock options and bonus payments and have markedly increased revenues in our budget.

How we handle those stock market-related taxes, if I may put it that way, in the future projections is very crucial to how much you think the surplus out there is going to be.

I merely wish to comment as an issue of caution that while we haven't seen the other side of a stock market decline, and hence, its potential impacts on revenues, it is instructive to observe that the Japanese had a quite similar phenomenon; their revenues rose far faster in the latter part of the 1980's than their nominal taxable incomes, and subsequent to 1990, it went exactly in the opposite direction.

So before I would be very comfortable about the existence and solidity of these surpluses, I would like to see some evidence in more detail of how we are projecting and expecting the outcomes of the revenues on the other side of this cycle.

Having said that, let me just repeat what I have said before you previously. Reducing the debt to the public is a very important and useful thing for economic growth. It creates lower interest rates, the level of interest payments falls, the level of the total spending falls because of that, the surplus rises even more, and it is a virtuous cycle which evidence suggests decreases real long-term interest rates, and over the long run probably increases growth. So don't immediately dismiss the advantages of just having the surplus exist and the debt be paid off accordingly.

Having said that, I am fully aware that that is very difficult to do, and if I am given my choice as to the long-term stability of the fiscal process, I would much prefer to see taxes cut than expenditures raised to diminish the surplus. But my first choice is still to reduce the debt, which is another way of saying there is no need to rush into any particular action, because the debt will be reduced automatically, as long as the surplus exists.

Chairman CASTLE. Thank you.

Ms. Waters.

Ms. WATERS. Thank you very much.

Chairman Greenspan, as you know, there is a raging debate about replenishment of the International Monetary Fund going on here in Congress, and we are constantly reminded that the Asian crisis may cause a tremendous negative impact on our economy.

While some of us are looking at this very closely, we are still concerned about some of the problems that were articulated here this morning about communities that are still trying to be involved in this growth that we are witnessing in our own country. So while we are cognizant and aware of the problem of the Asian crisis, we are still trying to deal with these communities that are not benefiting from the growth here in America, and we need what we are calling a domestic fund of some kind in order to invest in these communities and have some growth.

As I look at the great mergers that are being contemplated and your role in that, what do you think about capital formation strategies that would encourage those who are moving into these big mergers to get involved with this? For example, many of the banks or some of the banks who are talking about merging and some who have merged in the past made commitments or are making commitments.

I am told that Mr. Sandy Weil up at Travelers just made a commitment of $2 trillion to be invested in communities as a result of the merger. We had Wells Fargo, I believe, when they merged in California, that made a $40 billion commitment. I think Bank of America at one point in time made had a $30 billion commitment. But we cannot track these investments. We do not know what happens with these commitments.

We think that if there is a domestic fund of some kind that is put together by those who are getting involved in these big mergers, we could help them honor these commitments that they make for huge sums of money. We believe that there are strategies for formulation of capital where we could show a return on investment, where we could help people get involved in joint ventures, we could invest in businesses that oftentimes are overlooked but have tremendous potential.

We are not talking about grants, we are not talking about giveaways. We are talking about putting together the kind of plans where people who know what they are doing could take this capital and place it out there in businesses and opportunities that would certainly have a return on investment. We need some discussion about that.

I want to know what you feel about that. Would you be willing to even look at some of these plans to at least make some comments about viability or sensibility? We are interested in capital formation for growth in our communities.

Mr. GREENSPAN. As you know, Congresswoman, I am a very strong supporter of trying to get equity investments into the inner cities. Initially it is probably worthwhile to get an awful lot of debt where it had not been feasible previously. But unless you get a mixture of debt and equity, you will end up with an extremely difficult balance sheet which is very hard to service and does not promote economic growth. You need risk capital in there.

Ms. WATERS. Yes.

Mr. GREENSPAN. The issue of the substantial agreements or substantial dollar amounts which are involved in a number of these agreements are not part of the supervisory or regulatory structure of the Federal Reserve. We cannot enforce a private agreement between two parties.

It strikes me that the problem is to try to trace what they are doing and what they are not doing, and we try to do as much of that in our CRA exams as we can. But we cannot get to the point of literally tracking, dollar for dollar, what they agreed to in a number of these private agreements. I should think that if there is a problem of evaluation of action and enforcement, that those would be issues which would be in some way addressed as part of the agreement.

In other words, my suspicion is that the vast proportion of these agreements are entered into with full good will and are probably very substantially implemented. If there is a concern on your part, the only way that I am aware of which could conceivably capture whether or not anything of substance is happening is to have in the agreements some mechanism by which there is communication between the private parties as to whether or not they are being fulfilled and in what manner.

As I said previously, I suspect that you will find, if you do that, that in most instances they actually do what they say they are going to do. But short of some means of evaluation, I, too, would not know whether or not you could certify that indeed, if a commitment was X, that X was actually implemented.

Chairman CASTLE. Thank you, Ms. Waters.

Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

Chairman Greenspan, as you well know, I represent a region of the Southwestern United States that is very heavily into agriculture production and energy production. In those two industries, in agriculture, thanks to, at least through the first quarter of this year, some very favorable weather, which has now turned in the other direction, and to a degree both in agriculture and energy, because of the financial problems in the Western Pacific, Eastern Asia, the effect it has had on demand, we have had declining cash prices for both grain and energy.

Could I get you for a moment to share, perhaps, some of your insights or feelings in regard to what the potential impact is on the economy as a whole as we see this what I would describe as vulnerability of both industries coming to the top, here? I would add, also, that my constituents think they have damned well done their part to provide price stability by having declining energy and agriculture prices this quarter.

Mr. GREENSPAN. Most price stability is not voluntary, Congressman.

Mr. LUCAS. Good point.

Mr. GREENSPAN. You can observe the emergence of the crisis last fall with a dramatic weakening in all sorts of commodity prices, from oil through materials to agricultural products, pretty much across the board.

In oil it is fairly apparent that what has happened is that you have taken out a chunk of the expected increased demand in East Asia, which has been a very large part of the expected world demand for crude oil. In fact, it is working in reverse.

What happens is that it does not take very long for oil storage facilities, both at the crude level and at the product level, to fill up very dramatically. We have even seen examples of inventories now being held in tankers, which is not an efficient way of doing it. So we have effectively glutted the market, and the price effect has been pretty pronounced.

There has been an endeavor on the part of a few producing countries to cut back, and that has evidently firmed the price somewhat from its June nadirs. But it is still, obviously, quite low and is having a significant impact, incidentally, on drilling rig activity.

Much the same has occurred in agriculture. The weakening of prices has been fairly pronounced, and we also see it in our export performance, which is in part being hurt by the fact that a number of the grain exporters like Canada and Australia, because they are also commodity producers, have seen their currency weakened vis-a-vis the American dollar, which means that their competitive positions have marginally improved relative to ours.

So all in all, the Asian crisis, as I indicated in my prepared remarks and others of your colleagues have commented on, has had a positive effect because it has lowered interest rates and a number of other things in the overall economy, but that has clearly not been the case in both agriculture and energy in the United States.

Mr. LUCAS. Absolutely. It would appear at least the local perception is that, because both industries are very capital-intensive, if we continue in the direction we go, and that optimism that permeates, it seems, virtually the whole economy starts to dry up in those two areas, that by not making the long-term capital investments, that we could come to a point where we will start down a different trail. And even with the recovery, it might well take another extended period, as we went through in the late 1980's and early 1990's, to cycle back up again. So there are some real concerns there.

You would agree—I would assume, I think—that you would agree that the best solution there is to attempt to, in some form or fashion, help our consumers and customers, so to speak, recover their vitality?

Mr. GREENSPAN. Indeed.

Mr. LUCAS. Thank you.

Chairman CASTLE. Thank you.

Mr. Frank.

Mr. FRANK. Mr. Chairman, I was impressed, at the bottom of page 8 onto page 9, you talk about the great many chronically unemployed people given the opportunity to work; people have upgraded their skills, welfare recipients absorbing—there has been a significant increase in the utilization of sort of low-skilled workers at that level.

Over what period of time were you talking about?

Mr. GREENSPAN. The last two or three years.

Mr. FRANK. In other words, exactly the time that the last minimum wage increase went into effect. Can we infer from that that the increase in the minimum wage did not have the negative consequences on employment that some people predicted it might have?

Mr. GREENSPAN. No. I would say the minimum wage did have a negative effect. It has just been overwhelmed by far stronger forces.

Mr. FRANK. So overall, if we had not passed the minimum wage, would employment rates have been higher?

Mr. GREENSPAN. Well, possibly, yes. Let me put it to you this way.

Mr. FRANK. If they were, wouldn't you have had to raise interest rates? So in other words, you have told us in your statement that employment—the biggest potential cloud on the horizon that you see appears to be the inadequate growth in the worker force.

Mr. GREENSPAN. I would not argue that a rise in the minimum wage by restricting employment is good monetary policy, because it reduces——

Mr. FRANK. I would not, either. That is not what I am arguing. What I am trying to do—see, I think what happens is sometimes there is this ideological screen that gets in the way of the facts. If the theory is good, so much the worse for the facts.

The fact is that you have a whole statement in here about how we are outrunning our ability to find workers; that the biggest problem is the work force. That happened during the time the minimum wage was increased, so that any overall negative effect of increasing the minimum wage, in macroeconomic terms, appears to be zero.

Mr. GREENSPAN. Look, if you are asking me——

Mr. FRANK. What I am asking you, I am not "iffing"—I am asking you what I am asking you, which is, given the circumstances in which we increased the minimum wage, what negative effects did that have on the economy?

Mr. GREENSPAN. I would say at this particular stage none. But the issue is longer term.

Mr. FRANK. I will settle for none now, because the notion that with that relatively small increase, you are going to have a longer-term effect is fine, because, besides, since you came out against tax cuts, I don't want to argue with you too much today. We are on the same side, being against tax cuts. You may have lost yesterday on the economy, you may lose today that you are against tax cuts. As to two and three we have different views, but I am with you on one. The number one priority was tax cuts.

Mr. GREENSPAN. I didn't say I was against tax cuts. I would prefer that at the moment we let the surplus run, because it is——

Mr. FRANK. Which means no tax cuts right now?

Mr. GREENSPAN. That is correct, right.

Mr. FRANK. You were not against tax cuts forever, let me stipulate. You have not said that the minimum wage might not cause problems in 2006, and you have not said you were against tax cuts forever, but as for now you would prefer letting the surplus accumulate and reducing the debt to cutting taxes?

Mr. GREENSPAN. I would say there are unquestionably numbers of people, not many, but numbers of people who probably are not working today because the minimum wage is higher, and could have been working.

Mr. FRANK. Although, on the other hand, as we say, if, in fact, that had happened, they probably would still not have been working for different reasons. You would have had to raise interest rates. We have already stretched——

Mr. GREENSPAN. It is a supply factor. I am saying that these people who are held down because they cannot produce at the level of the minimum wage are being held out of the market.

Mr. FRANK. We are running out of workers in the economy. You are saying that the economy needs workers, but it does not—these workers——

Mr. GREENSPAN. Unfortunately, what you need is workers whose productivity matches what they get paid. You do not want to distort the market in that regard. It does not help them.

Mr. FRANK. Except that, again, it seems to me, overall, the point that we have, in fact, overstretched the work force makes it very hard.

Let me just go back. I will accept the fact that you said it had none to date. People can speculate about the future. I will accept that for now.

The other problem we have, though, is the continued disproportion in the values. What is fascinating is how optimism can become pessimism, and vice versa.

I know there are people for whom every cloud has a silver lining, but there is this tendency, I think institutionally, for the Federal Reserve, while some people look for the silver lining in the cloud, it is your job to remind people that the sun causes cancer, and I think that is what we are basically doing here.

On page 22, you say, "We expect the situation will develop smoothly." This is the crux of my concern. "The committee believes that the potential for accelerating inflation is probably greater than the risk of protracted, excessive, weakness." It is the imbalance there.

Yes, I am sure that is true. An acceleration in inflation, versus two adjectives on weak conditions, weakness, we get one noun and two adjectives. And the acceleration is the problem over here, but it is protracted and excessive.

What is the danger of protracted, excessive inflation? That is the problem. It is the disproportion. Any inflation is to be more feared than a protracted—it equates to a protracted, excessive weakness. That is the problem.

There is an institutional bias to overemphasize the threat of inflation and, as I said, if you had said the potential for accelerating inflation is probably greater than the risk of weakness in the economy, I would have passed over it. If you would have said the potential for rapidly accelerating inflation is greater than the risk of protracted, excessive weakness in the economy, I would give you two adjectives for one, it would not have been a problem.

But I really do believe this reflects the mindset where any inflation equates as a harm protracted and excessive weakness. I think that is the danger in the policymaking that I fear.

Mr. GREENSPAN. It is not an institutional bias, it is an institutional evaluation. If, as we think, the evidence has increasingly affirmed in recent years that low inflation or stable prices is a major contributor to sustainable, long-term economic growth, then if we are concerned about the reemergence of inflation, as we should be, it is because it is a threat to sustainable, long-term economic growth and employment. In that regard, I should think that we ought to be more concerned about the emergence of inflation than of temporary economic weakness.

In that regard, yes, I would acknowledge that the central bank's major concern is stability of the currency, which is what a central bank should do. I can conceive of an argument which we did have, say, several years ago where the hypothetical question of price stability increasing economic growth over the long run was an arguable case. We asserted it, but recognized that the evidence was mixed.

What we have found in the last four or five years is a very considerable addition to the case that a necessary condition for long-term stable economic growth and employment is a stable inflationary environment, a noninflationary environment.

Chairman CASTLE. Ten seconds.

Mr. FRANK. Ten seconds.

I don't deny that should be the focus of the central bank. What I am concerned about is excessive deference to a central bank which has exactly the orientation you say, which, in my judgment, exaggerates potential inflation and undervalues growth.

Chairman CASTLE. Thank you.

Dr. Paul.

Dr. PAUL. Thank you, Mr. Chairman.

Mr. Greenspan, over a period of time, the dollar has been weak. If you look at it from 1971 until now, the curve is obviously downward. If you look at the last three years, the dollar has been relatively strong, and some people consider this a problem. Even our Government, our Fed and Treasury, just recently thought our dollar was too strong.

Of course, in free markets, the purchasing power of money is never tampered with, but under today's conditions it was felt that it was too strong in relationship to the yen. Of course, we intervened and had some effect to the currency markets.

When do you suppose the time would be appropriate for the money managers to intervene in a much more aggressive manner, if the dollar continues to be very, very strong, and pressure is put on the Federal Reserve, political pressure, to say, "We cannot sell our goods, we want some help"? Can you foresee that? And not a token amount of interference, intervention in the market, but a major intervention in the market to change the direction of the dollar, can you foresee that in the near future?

Mr. GREENSPAN. Congressman, let's first emphasize that we do consult with the Treasury and ultimately the Secretary of the Treasury is the legally authorized determiner of the extent to which intervention occurs or doesn't occur. The Secretary has indicated on numerous occasions that it is fundamental values which will determine the value of the dollar and other currencies, and over the long run, intervention doesn't do very much one way or the other. I think that the evidence over the years has demonstrated that that particular statement is clearly sustainable.

I can't anticipate what particular policies will be under hypothetical circumstances. It is an important question, there is no doubt. But overall, the presumption that somehow we, meaning the monetary authorities, the Fed and the Treasury, can somehow alter the value of a currency in a significant manner when fundamentals are going in the opposite direction is an illusion. We cannot.

Dr. PAUL. So in a way what we have done just recently was just wasted money, since we do know that intervention does not have much effect? Why do we bother on occasion——

Mr. GREENSPAN. First of all, we don't waste money. We are taking a position in a currency, and very often over the years we turn out to actually have a profit in the process. When you intervene, you don't spend the money. You are just taking an investment position or a speculative position.

Dr. PAUL. Unless that currency happens to go down, which it well could.

Mr. GREENSPAN. Yes. That is certainly the case, and if you do it in large volume, then the answer is there are speculative risks. We have taken very few of those.

The very few times which we intervened, and we have not intervened for years until this most recent event occured, was when we believed that the markets were unstable and that intervention might have an impact. You need both of those conditions to exist. It was the judgment of the Secretary of the Treasury, to which we agreed, that action taken would have the effect of breaking a pattern of a very quick run in the currency. I don't think any of us believed it would have more than a temporary impact.

Dr. PAUL. A very quick question. You seem to welcome, and you have been quoted as welcoming, a downturn in the economy to compensate for the surge and modest growth in the economy. Is it not true that in a free market, with sound money, you never welcome a downturn in the economy? You never welcome the idea of decreased growth, and you don't concern yourself about this? And yet, here we talk about when is the Fed going to intervene and turn down the economy?

It seems that there is a welcoming effect to the fact that the Southeast Asia has tampered—you know, price pressures. Couldn't we make a case that the free market would operate a lot better than the market we use today?

Mr. GREENSPAN. I think you have to define what you mean by a "free market." If you have a fiat currency, which is what everyone has in the world——

Dr. PAUL. That is not free market.

Mr. GREENSPAN. That is not free market. Central banks, of necessity, determine what the money supply is. If you are on a gold standard or other mechanism in which the central banks do not have discretion, then the system works automatically.

The reason there is very little support for the gold standard is the consequences of those types of market adjustments are not considered to be appropriate in the 20th and 21st century. I am one of the rare people who have still some nostalgic view about the old gold standard, as you know, but I must tell you, I am in a very small minority among my colleagues on that issue.

Dr. PAUL. So I guess we have to accept the downturns?

Mr. GREENSPAN. No. We are not accepting downturns, nor do I think we look at it as desirable. What we do look at is an economy which is running at a pace which is unsustainable over the long run and will eventually run off the tracks and create significant disruption. So we do not look forward to a weakening in growth. All we are concerned about is a pattern of growth which is sustainable.

In other words, when we talk about our goal as maximum sustainable economic growth, the "maximum" and the "sustainable" are both crucial elements to that. We can get a maximum growth in the short run, which is not going to help anybody over a longer-term period. That we would consider to be an unacceptable or undesirable pattern of growth.

Dr. PAUL. Thank you.

Chairman CASTLE. Thank you, Dr. Paul.

Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman.

I want to go back to the statement I made, Mr. Chairman, at a time when all of us get to talk and you don't, and you have to listen to us for a minute or two, or for more than that.

I want to lead into it by following up on the comments that you just made with Dr. Paul. It seems to me that if you look at the general state of the economy, and you look at all the numbers, the aggregate numbers, they are all very, very encouraging. But there are some storm clouds that would appear out there on the horizon.

You have a major General Motors strike. You have got Bob Rubin, who has been rumored to perhaps be leaving the Treasury Department. You have a major crisis that is almost every day on the front page of the newspapers with regard to Japan, that leads to an Indonesia crisis. It could lead to a Korea crisis, as well. You have got a potential war between India and Pakistan. You have mentioned inflation a number of times, there is a tight labor market, and how all of those sort of play into your maximum sustainable growth policy.

If I understand it, there was a period of time in the late 1960's that the stock market came close to a thousand points, and it then, I believe, declined, really, for a period of almost 13 or 14 years. I think that there is a whole group of investors in this country that, for the first time in their lives, have an IRA or some kind of Keogh or retirement plan. They look at these reports that they receive from their money market managers that tell them every month that their portfolios have increased by another 5 or 10 or 15 percent, and they look at these numbers that come in, which tell them that they have for the first time in their lives this real wealth.

I just wonder what advice or what thoughts you have; not really advice, but whether or not you feel that the notion that somehow this economy can never, in fact, adjust will create perhaps even greater problems if, as has always occurred, there is an adjustment, and if, for the first time, people actually see losses, and how they will react to those losses, and whether or not that bears on your thinking and perhaps other members of the Market Committee's thinking in terms of how to deal with what you view as, it seems, unsustainable growth.

Mr. GREENSPAN. We don't view the current growth rate, say, during the last few years, as unsustainable. I have argued elsewhere, and indeed this morning, that productivity, as best I can judge, is probably accelerating. That in and of itself, with the same labor force, will give you greater economic growth overall. I suspect that the evidence suggests that that is indeed happening.

But the broader question you are raising is the issue of the emergence of a really quite extensive expansion in the holdings of equities among households which have risen by almost a half, depending on how you mark it, and who holds it.

It does turn out to be that the very substantial amount of capital gains is in the upper and middle income groups and above, and the dangers that you have if you count on these types of expansions are largely whether or not you took out debt against it. In other words, the only way you can spend, so to speak, your capital gains is either to sell your stock and get the cash or somehow borrow, not necessarily against the stock, but with the feeling that you have this huge block of new assets, you feel as though borrowing is not a particular problem because your balance sheet is in such good shape and your net worth is so much better.

The real danger exists if there is an awful lot of debt which, in the event of a significant stock market contraction, that all of a sudden becomes unserviceable.

Mr. KENNEDY. Isn't there also an issue, though, Mr. Chairman, that where people for the first time recognize that they can actually lose money in the stock market, and therefore pull out of the stock market, that that could create a much greater downturn in the stock values than might be normally anticipated as a result of these other economic indicators?

Mr. GREENSPAN. I doubt it. In other words, the market ultimately is driven by real forces. Once you get a decline started, it is not clear whether, in fact, people choose that as a reason to sell or to buy. Indeed, most of the evidence of recent years is that people who have built up 401(k)s and other forms of investment and have become quite familiar with the stock market have been the ones who have been buying on the declines, and indeed, have turned out to be prescient, and wealthier.

So it is not clear exactly how they are going to behave. Forecasting that they are automatically going to start to sell any more than the full professional managers of large pension funds would—is probably futile, because we——

Mr. KENNEDY. Do you believe there is going to be a market correction which could result in a significant contraction in the size of their portfolios?

Mr. GREENSPAN. I would say, ultimately, yes. History tells us that there will be a correction of some significant dimension. What it doesn't help you on very much is when. Indeed, history is strewn with periodic contractions of significant dimensions, and I have no doubt that human nature being what it is, it is going to happen again and again and again. How individuals behave in that particular environment is not clear or necessarily forecastable.

Mr. KENNEDY. Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, very much, Mr. Kennedy.

We will next go to Dr. Weldon. After that we will switch sides. Mr. Leach will be after that, Mrs. Roukema, and then Mr. Metcalf, just so people will know where they are, because it is always a little bit of a problem. We will keep going in order over here.

Dr. WELDON. Thank you, Mr. Chairman.

Mr. Greenspan, you in your testimony made a statement that changes in monetary policy here would have an outsized effect in Asia. I am assuming you are talking about an increase in interest rates in the United States would have a disproportionately large effect there. Could you just elaborate on that a little bit, please?

Mr. GREENSPAN. Certainly.

The American dollar has become a key currency throughout the world, and especially in Asia.

Dr. WELDON. Is that really a reserve currency throughout the world?

Mr. GREENSPAN. To a very substantial extent, the reserves of central banks are disproportionately in the U.S. dollars, and that is true of Asia as well as even Europe. The consequences of dollar-denominated interest rate changes, as a result, are really important.

Obviously, if they, as indeed a number of the economies did, tied their currencies to the dollar, either tightly or sort of in a modest way, they will pick up dollar interest rate effects in their economies, which has an impact of not insignificant proportions, if, especially, their financial systems are fragile or weak, as they are today.

So when we discuss monetary policy, one of the major areas where considerable interest exists far beyond the academic interest of central bank policy are in those areas which find the value of the dollar, both in the exchange market and dollar-denominated interest rates, which a lot of them borrow in, of quite significant importance to them.

Dr. WELDON. Are you following the developments in Indonesia at all?

Mr. GREENSPAN. Yes.

Dr. WELDON. I recently read that the cost of basic commodities for the Indonesian citizens is extremely high, particularly food. Can you comment at all on that, and the implications of that? Because there are some reporters in the media making claims that the country is on the verge of chaos, and certainly, though our major concern here today in this hearing is the United States economy and United States policy, we all know that developments like that can have implications for us domestically.

Mr. GREENSPAN. Whenever you have a currency fall as sharply as the rupiah has fallen, which is approximately 80 percent, and you import any significant amount of materials or foodstuffs, which they do, then clearly the domestic price of many of the things which they import obviously skyrockets, unless, as indeed there is the case currently, at least to the extent that the Government does not subsidize them. The Indonesian government does do a considerable amount of subsidization for foodstuffs that are imported, but nonetheless, prices have risen to extraordinarily high levels.

The food distribution system also has been disrupted by a goodly number of political problems, especially with the ethnic Chinese, who have been major players in the distribution system in Indonesia. As a consequence, there are concerns, increasing concerns, of food shortages and food prices which are too high for those average Indonesian citizens to afford.

Dr. WELDON. I am going to run out of time in a second. Let me get to the meat of the question that I wanted to ask you. Can you comment on the involvement of the IMF in the developments of Indonesia, particularly in light of the political situation where many people are asking for more involvement of the IMF?

Mr. GREENSPAN. Yes. As I indicated to you earlier, the crisis that emerged in Southeast Asia was not forecastable, and indeed, as it began to evolve, the extent of how deep it would become was also not forecastable.

Vicious cycles, which Indonesia's economy was characterized by more than any of the others, was a massive implosion that was very difficult to handle, and I think that the IMF has done as much as it thought it understood it could do. I don't know what alternative policies could have been implemented which would have significantly altered the pattern that emerged once the vicious cycle began to accumulate in the degree that it did.

Dr. WELDON. Did the IMF policy play a role in the 80 percent decline of the value of the rupiah?

Mr. GREENSPAN. I think not. That results largely from the internal policies of the Indonesian government, which were inadequate to the nature of the problem that they confronted.

Dr. WELDON. Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Weldon.

Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman.

Good morning, Mr. Greenspan. Reports in the press yesterday after your testimony interpret your remarks that the Fed will raise interest rates because of the threat of inflation. Could you clear the air today, or would you rule out that interpretation?

Mr. GREENSPAN. I don't think that is what I said. I said very much what I said this morning, which is that there are lots of ifs, ands, or buts in those types of evaluations. What I did say is that we are on a path at this particular point, with the working age population, including immigration, going up at about 1 percent a year, and the job growth, as a consequence of economic growth affected by increases in productivity, is running 2 percent a year.

That gap is being met by a fairly pronounced reduction in the number of people who are either officially unemployed or those who are not in the labor force because they are not seeking jobs actively, but who nonetheless say they would like to work. The combination of those two groups of people in our society is declining fairly rapidly, reflecting the difference between the 2 percent growth in employment and the 1 percent growth in the working-age population.

What I have been saying for actually quite a long period of time is that somewhere, at some point, that gap must inevitably close, because we will run out of people to employ. Prior to that happening, either it will occur because the economy slows down by itself, which means that employment growth will slow down closer to the gain in the working-age population, or if it doesn't happen and wages accelerate as a consequence, if the laws of supply and demand exist—and you have free labor markets—history tells us that wages will tend to accelerate.

If that happens in excess of the growth of productivity, and to date it hasn't, then other actions, mainly monetary policy, may have to be involved in order to constrain what would be, effectively, a destabilizing adjustment, which could have a major negative impact on the economic prosperity, which has been so extraordinary and so beneficial to this economy, especially the remarkable things it has done to enhance the quality of our work force, who have successively been able to gain the skills and move up the scales because the labor market has been as good as it has.

Mrs. MALONEY. My colleague, Mr. Frank, pointed out today, your comments on page 22, the potential for accelerating inflation is probably greater than the risk of protracted, excessive weakness in the economy. As I said, some of the press interpreted your comments yesterday and then your comments today—they seem to sound like there is a bias toward raising interest rates. You are saying that that is not true, that you are open to any policy, even lowering interest rates?

Mr. GREENSPAN. I am saying at the moment that the most probable outcome, as I stipulated in my prepared remarks, and indeed, I even quoted some of the prepared remarks, is that we are going to get a continuation of what is really quite a remarkable and benign economic environment.

To the extent that we see that the probabilities that that does not happen—the minority probabilities, the less than 50 percent probabilities—are, as best we can judge the environment, more likely skewed in the other direction, than if we are wrong in the evaluation we are making, namely, that things will be reasonably stable and benign, the probability is greater that we will end up with an acceleration of inflation, as distinct from a weakening, or as Barney Frank said, an excessive weakening in the economy.

That is a statement of the way we view the probabilities, but let me assert what I in fact said, and I will repeat it; namely, the most likely scenario is more of what we have seen in the most recent past.

Mrs. MALONEY. Very, very quickly and briefly, after the Russian loan, the IMF is dangerously low in their reserves, down to $7 to $12 billion.

What will happen if we follow the leadership of the Republican Majority in their call not to fully fund the International Monetary Fund? What happens with Asia and other countries that look to the United States for leadership? What will be the impact if we fail to fund the International Monetary Fund?

Mr. GREENSPAN. Congresswoman, as I have testified before this subcommittee previously this year, the probability is that if the funding is not made, that we will probably muddle through; that the probability that something significantly adverse will happen to the United States as a consequence is less than 50/50. In fact, it is a relatively small probability.

Nonetheless, if we are wrong and that probability, that event, actually emerges, then the consequences will be very severely negative for the United States. In my judgment, taking out what is effectively an insurance premium, which I believe the funding of the IMF would be, is a wise policy.

I am not saying that I think that at the end of the day we should not be looking at the whole structure of the international financial institutions, the IMF being, of course, the prominent one. I do think we are going to have to do that, because the global financial system is changing. It is just that I am arguing that now is not the time to do that. We don't have the luxury not to have available an institution such as an IMF, if it is necessary, to fund and assist in the containment of crises.

But after this situation in Asia becomes history and the world financial systems stabilize, then I think many of those who have been arguing that a review of the structure of the system is on the table I think are correct. We ought to be looking at it.

It is just that this is comparable to when your house is potentially burning down, and your neighbor's house is on fire and the sparks are going in your direction, your concern is to make sure that the fire doesn't spread. Tomorrow you can complain to the neighbor that they shouldn't have lit matches in their kitchen or something like that. It is just the timing is all wrong to do it in the midst of the fire.

Chairman CASTLE. Thank you, Mrs. Maloney.

Chairman Leach.

Mr. LEACH. Thank you, Mr. Chairman.

Whenever a Federal Reserve Chairman comes to the subcommittee under the Humphrey-Hawkins approach, it is always interesting to try to figure out what perspective to apply. It seems to me the biggest perspective to apply is that the Federal Reserve of the United States has just established a new economic doctrine, what I would describe is as, using your terms of art, Greenspan virtuosity.

You have talked about a new theory of a virtuous cycle, which, as I read your testimony, is characterized by accelerated productivity, which reduces inflation, which bolsters expectations of future corporate earnings, which increase equity values.

What is intriguing about this is it is the first conjunction of morality and economics that I have seen in terms of a label, so I have gone to the standard dictionary to look up what the term "virtuous" means for most people. "Virtuous" means righteous. It means, "characterized by chastity, or exhibiting virtue." So I looked up "virtue." That means moral excellence or righteousness, it means chastity, it means one of the order of angels. It comes from the Latin "virtus," which means manliness or goodness. So what we have is a chaste, manly economic doctrine that I think is of serious significance.

Having said this, this appears that it is an economic virtue to have lower inflation. One of the interesting theoretical notions that has come into being or has been in being in pastimes in history, and people have thought might be passe, but may not be, is the question of deflation. Is there virtue in deflation? Is this a circumstance that the Fed is concerned about?

Some have suggested that we may have a global overcapacity in manufacturing, and that there may be seeds of a deflationary trend. Is the Fed concerned about this, and will there be a policy response if there is a concern? Is a policy response other than lower interest rates the only kind of response to meet this type of circumstance, or might there be others?

Mr. GREENSPAN. Mr. Chairman, let me emphasize that our goal is price stability, not price deflation; or, more exactly, not noninflation. Noninflation includes price stability and deflation. That is not the goal, as we see it. Indeed, as we evaluate the relationship between inflation, price stability, and deflation, to the extent we are able to analytically disengage or disaggregate the effects on the economy, it appears that both inflation and deflation, because they create uncertainty and risk premiums, are consistent with a slower rate of maximum sustainable long-term growth than price stability.

Price stability would have the lowest set of risk premiums, because if you have a set of prices which are generally stable, some prices will go up, some prices will go down, the risk into the future is perceived to be less, and hence, the degree of investment will be more, productivity growth will be more, and standards of living will be rising faster.

So we would be just as adamant against the instabilities and rising risk premiums that would be associated with deflation as we would with inflation. We do believe that there are forces out there in the rest of the world which have clearly moved from inflation to disinflation and, in certain areas, deflation.

We do not believe it has moved anywhere near in that direction in the United States as yet, but were we to see that occurring, or were we to see the stampede from a small dot to something much larger coming, obviously, we would evaluate and respond to it as we perceive appropriate.

Mr. LEACH. As men and women of virtue? Yes. Thank you.

Mr. GREENSPAN. Yes. With respect to the rest of your statement and questions, Mr. Chairman, you do leave me speechless.

Chairman CASTLE. Thank you, Mr. Chairman, for your chaste, manly questions. We appreciate that.

Mr. Jackson.

Mr. JACKSON. Thank you, Mr. Chairman.

Welcome back to our subcommittee, Mr. Greenspan.

Just two questions, if I may. I want to pick up on something that Representative Maloney said just a few moments ago, in an analogy that you used; her question, again, regarding the International Monetary Fund.

I believe your quote went something to the effect that when a neighbor's house is on fire and sparks are coming our way, what do you do? The IMF is a way to contain the fire. Unfortunately, because this is an election year, the IMF and its replenishment may be bogged down in election year politics.

Your agency was created, in part, to be free of political influences and considerations. I am interested in how you and your agency contain fires of the magnitude of the Asian crisis so that the effects of contagion or the sparks do not undermine our economic growth and expansion. And a hypothetical, and I am sure in the world of economics we deal with them all the time, if the fire does spread, does that mean higher or lower interest rates?

And then I have a second question unrelated to this one.

Mr. GREENSPAN. Congressman, it is very difficult to evaluate potential hypothetical events without fully grasping all of the complexities of what they are when we make policy. I have tended to stay away from trying to project what we might or might not do under certain hypothetical cases, because I have found that, over the years, when those cases actually emerge, they look quite different from the way I thought they would. The reason is that we have such an extraordinarily complex economy that it tends to do things which surprise us more often than not.

Obviously, to the extent that deflationary forces are moving in the way the Chairman was indicating earlier, clearly they raise questions as to how we might or might not respond. But raising interest rates in the context of a deflationary set of forces is obviously not something which central banks as a general rule engage in.

Mr. JACKSON. I guess I am going to follow up on my first question. I want to make it clear that, again, the ability of this Congress—in light of this being an election year, it may not be possible for us to fully replenish the International Monetary Fund for political reasons. All of us are facing reelection. It is very difficult to argue why we should be bailing Asian economies out and why we would cast a vote to bail out an Asian economy.

Yet, in your remarks to Mrs. Maloney, you indicated that our neighbor's house is on fire, which it is clearly on fire. Chairman Leach and I took a trip, along with Members of this committee, and we studied the nature of the fire. You said that sparks are potentially coming our way. Now, I don't know what size those sparks are, but one——

Mr. GREENSPAN. Nor do we, essentially.

Mr. JACKSON. I am assuming then that your remarks are either to downplay the significance of the sparks or to acknowledge that the sparks are of an enormous magnitude, and one way to contain the fire is to replenish the International Monetary Fund until such time as we are able, beyond this particular crisis, to develop the appropriate international monetary funding agency and discuss some of the problems that we have with the agency in general.

So in case this institution is incapable of responding to the magnitude of this fire. Whether it is a small fire, whether it is a large fire, it is clear that your agency is the next line of defense in terms of fire containment and spark containment. If it is a small crisis, your agency will respond because the Congress couldn't. If it is a large crises, your agency will respond because of the nature of the crisis. And my only question is if it is a fire that is spreading, in which direction, higher or lower, based upon the magnitude, small or large, is your agency likely to respond?

Mr. GREENSPAN. Higher or lower interest rates, is that what you mean?

Mr. JACKSON. It is usually the response from your agency when there is some——

Mr. GREENSPAN. As before, as I indicated in my prepared remarks, it is very clear that the contagion that has occurred and the crisis that has occurred in Asia, and indeed in a goodly number of other parts of the world have been factors which we think have diffused some of the underlying inflationary pressures that were building in the United States. In that regard it is pretty clear that if those forces, international forces, were not there and events were developing the way they were in the last two or three years, I would say that the pressure for us to have tightened monetary policy further would clearly have been higher. So in that regard, obviously, the extent to which there is a degree of weakening in the rest of the world which is spilling over into the United States, that, as other things equal, kept interest rates somewhat lower in the United States, in the short end of the market I should point out.

Mr. JACKSON. I thank you for that response, Mr. Chairman, and what that tells me is that there indeed then is no pressure on this Congress at all to replenish the International Monetary Fund because there are international forces that have somehow reconciled and provided us the time that we need, and unfortunately many of us in the Congress have been operating as if there is great pressure for us to replenish this particular fund under certain conditions, that notwithstanding.

Mr. GREENSPAN. May I just—no, I would disagree with that.

Chairman CASTLE. May we go on to——

Mr. GREENSPAN. Let me disagree with that.

My position is that it is precisely because we do not wish the contagion to get out of hand and create exceptional problems for the United States that I have argued in favor of the replenishment.

Mr. JACKSON. I thank you, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Jackson.

Mrs. Roukema.

Mrs. ROUKEMA. Thank you.

As it turned out, my questions will give you the opportunity to follow up in a very real way and amplify on what you were just saying with respect to IMF. I will get to that, but first let me say that particularly given the report in the *Wall Street Journal* today on massive tax cuts being planned by my Republican leadership. I have heard you, and I hope this group and the press have heard you loud and clear, that relative to paying down the national debt, waiting for the surplus to solidify and maintaining the balanced budget, that you would delay tax cuts.

If you want to comment on that, please do. Maybe you would like to tell us which tax cut you would give a priority to.

But first I must get back to that IMF question. I am glad that you said to Mr. Jackson that it should not be interpreted that you are not supporting IMF. You do indeed support IMF funding. When I read my opening statement, I had not known that our House Appropriations Committee yesterday deferred indefinitely, and probably until September, acting on the appropriation for the IMF.

I would like to have you, Mr. Chairman, speak very definitively on why this is not a bailout and why this is in our own economic self-interests, and what could be the consequences of deferring indefinitely this proposal.

I am deeply concerned that problems have now resurfaced again and caused this delay. I am convinced that you and the business community have got to undertake an offensive here to help us get the IMF funding passed. We do not want to provoke a worse situation where the contagion really is spread. We are not talking about cinders any more, or fire hazards from one house to another, but we are talking a real conflagration.

Mr. Chairman, please.

Mr. GREENSPAN. Congresswoman, I haven't changed my view on this since we discussed it in this subcommittee early this year, and indeed even late last year.

The issue is that there are significant emerging contagions throughout the world. The crisis, as I indicated in my response to the Chairman's first question, has shown no evidence of stabilization at this point. We do not know how far it is going to carry or what its spillover is going to be. It is very difficult to forecast this. There are those who make forecasts. I know that the basis of those forecasts are very fragile.

As a consequence, the concern that we ought to have is that with the resources of the IMF significantly depleted, which indeed, as I indicated in the Senate yesterday, they are, that we can take the risk that there will not be replenishment, that there will not be significant resources available easily for the IMF to contain the particular conflagrations that may arise which we cannot immediately foresee. We can essentially position ourselves to hope that nothing happens as a consequence of these events, and the chances are, frankly, we probably will luck out in that regard, and no particular action will be required. But if we are wrong in that regard, the consequences could be very substantially negative for the United States, and as I said to one of your colleagues earlier, I view that as an issue of taking out insurance, important insurance. While I acknowledge, as many of the critics of the IMF have indicated, that there are many things that ought to be changed there, I think now is not the time to do that. There is more than enough time to address this after this crisis is over.

Mrs. ROUKEMA. Would you care to comment on the question of waiting until September to act on IMF funding?

Mr. GREENSPAN. There are risks involved in doing that. It is important more that it be done in this particular Congress than it be delayed, because the real danger is to delay when the Congress is not in session.

Are there risks in delaying until September? I think there are. I do not think they are major risks. The real risk is to do nothing after the Congress adjourns. Then I do think we have a situation in which there is nositting Congress easily available, and if the crisis were toarise, it would be very difficult to address expeditiously.

Mrs. ROUKEMA. Thank you.

Chairman CASTLE. Thank you, Mrs. Roukema.

Ms. Lee.

Ms. LEE. Thank you, Mr. Chairman.

Chairman Greenspan, I mentioned in my opening statement that I am still trying to get some understanding of this definition of full employment as defined by the Humphrey-Hawkins Act. It states expressly that Congress should establish as a national goal the right to full opportunities for useful paid employment at fair rates of compensation for all individuals able, willing and seeking to work.

Now, we know that in many of our communities, we see thousands of people work and walking around who are unemployed, yet we have this very low unemployment rate. We also know that many individuals are working, for instance, 20 hours a week at $8 an hour. Now under the full employment, the Humphrey-Hawkins Act, what constitutes the unemployment rate, and how do we view unemployment, or how do we define employment given what we know that is really occurring with many of our workers in this country are seeking work and are unemployed?

Mr. GREENSPAN. Congresswoman, the notion of full employment is something which goes back basically to the early post-World War II period as a concept which economists and policymakers tended to deal with in some detail. Prior to that we didn't even have the data to know what the degree of unemployment was. We didn't, for example, in the 1930's have the type of data system that we now have. In the 1950's and 1960's there were many different judgments about what is the rate of frictional unemployment, meaning the extent to which, if you had a free labor economy, there would undoubtedly be some people between jobs who are voluntarily unemployed, and clearly you don't wish that number to force people to work when they don't wish to work.

On top of that, there is supposed to be some various different evaluations of how much unemployment is stable over the long run.

What occurred in the 1970's is a set of stagflations, as they became to be known, which was really quite alien to the view that low unemployment would increase inflation and you couldn't have inflation with high unemployment. It turned out in the 1970's that you could. This led to this whole new notion of the optimum unemployment rate, which we now call the NAIRU, which is sort of related to the Humphrey-Hawkins requirements for the administration of 4 percent and I think it is 3 percent adult unemployment.

But even the NAIRU is now, as you know, coming under considerable uncertainty, and as a result of this, the language in the Humphrey-Hawkins Act is very rarely directly adhered to. It requires, I recall, in the language that the Administration indicate how it will obtain the unemployment rates that are embodied in the statute.

For the first few years, immediately thereafter, I do believe that such evaluations were embodied in the President's Economic Report. But that has not been the case in recent years. It has gone by the wayside because it has been perceived of as a more complex issue. So while it is still in the statute, it really is a throwback to earlier periods of the notion of full employment and what it means.

I don't know how to interpret it in today's environment. Administrations over the years have essentially chosen to discuss the issue, but not in the full detailed notions that are embodied in the statute. My own view is that it is probably advisable to revise the statute to bring it up to the realities of the current period, but that has not been an issue. That has been on the table in the Congress for quite a long period of time, as I understand it.

Chairman CASTLE. Thank you, Miss Lee.

Mr. Metcalf.

Mr. METCALF. Thank you, Mr. Chairman. I apologize for arriving late.

You may have covered the question, but I do have a couple of questions.

As you know, debate has emerged between economists as to the principle causes of the Asian crisis. One school lays the blame largely on ample global liquidity combined with weak national financial systems and the corrosive impact of crony capitalism. The other school asserts that the Asian economies were fundamentally sound, and that the rational herd instincts of market participants combined with the pernicious influence of short-term capital flows and poor IMF policy advice caused the crisis.

Can you comment on who might be right on this?

Mr. GREENSPAN. Yes, I think the first is more right than the second.

Mr. METCALF. OK.

Mr. GREENSPAN. In fact, I don't think the second is right at all.

Mr. METCALF. OK, thank you very much.

Second question. Regarding the Asian situation, I wanted to ask you how much Japanese markets are redeeming U.S. Treasury notes? They have been recently redeeming some, and we know that they hold a significant amount of U.S. treasuries. About how much do they hold?

Mr. GREENSPAN. I think 400—there is a technical problem that we have. I will submit a figure for the record. We are unclear on what information is private and what is not. Some of it, obviously, we get from the Japanese government, which is private, but what I will do for the record is give you a number. It is several hundred billion dollars incidentally.

[Chairman Greenspan subsequently supplied the following information:

[According to revised estimates by the Treasury Department, holdings of U.S. Treasury securities by Japanese residents (official and private) amounted to $264 billion at the end of April 1998. This estimate is based on the value of holdings of bonds and notes reported in the 1994 portfolio benchmark survey and Treasury International Capital reports of holding of bills and certificates as of the end of April 1998. Treasury makes no attempt to adjust their estimates of foreign holdings for changes in value resulting from changes in interest rates.]

Mr. METCALF. OK. Several hundred billion. OK.

Do you believe that we could see a scenario here where Japanese financial institutions feel that they are in such serious trouble that they dump large amounts of U.S. securities? Now, they are done with—selling some, but we see this as a potential problem. It seems to me that it is.

Mr. GREENSPAN. Well, it is conceivable, but remember that the rate of interest, especially the real rate of interest, doesn't really depend on who owns which securities, and very recently the Bank of Japan, in an endeavor with the Ministry of Finance to support the yen, sold huge amount of U.S. dollars actually through sale of securities, and the impact on the price was de minimis.

Mr. METCALF. OK. Thank you.

I have no other questions.

Chairman CASTLE. Thank you, Mr. Metcalf.

Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. I want to apologize to the Chairman for having to leave. We have a hearing going on in Judiciary right around the corner on hate crimes, and some days I feel like when I come to the Banking Committee and I go to the Judiciary Committee, it is the difference between day and night as just a whole dichotomy, two different worlds going on.

I perhaps should not even ask a question and let you out as quickly as possible since they tell me that the market has gone down another hundred points today, at least, and as 2 days you have been over here, we got to stop you from testifying if the market is going to recover.

Chairman CASTLE. Would you yield for a moment, because I made the statement earlier the market always goes up when he testifies here, so it is probably a pretty good time to invest because it is going to turn around and have a big bump before the afternoon is over.

Mr. WATT. Oh, you think it is coming back this afternoon? OK.

Let me ask a question that I hope is not duplicating something that was asked while I was out. In your opening statement you referred to a dramatic increase in labor productivity, and I recalled that in your comments in Charlotte, you spent quite a bit of time talking about the impact of technology on productivity. And I guess the first question I have is is it your assessment that this increase in labor productivity is attributable to a better prepared work force, or is that being driven by this technological advance in combination with just having people working with the technology? Which one of those things or ones of those things are driving this labor productivity, in your assessment?

Mr. GREENSPAN. I would say it is both, Congressman. That is, it is an interaction between a highly efficient capital stock in the United States and an increasingly skilled work force, and it is very difficult to disaggregate the two. We try in some of our productivity analyses to do that, and the truth of the matter is if you don't have any people, having the capital equipment there isn't going to help you. And if you don't have any capital equipment, having people, even if they are skilled, isn't going to create very much in the way of value added.

So it really is an interaction, and we call it labor productivity not because we are either implying that it is all out of labor, but it is merely a measure of the aggregate output per unit of labor input, because ultimately the standard of living of human beings is determined by the output per worker.

Mr. WATT. Let me then spin off from that issue to the question that I raised in my opening comments and ask you to address, and that is this issue of the aggregate unemployment, which obviously is important, but also in some areas, particularly inner-city areas, unemployment is still very high. Are there policies—or maybe I should just ask how can the Fed address that, that issue of the specific areas of unemployment, and in your assessments are you looking at just the overall unemployment in determining whether to raise interest rates, determining whether inflation has taken place or likely to take place, or how do you factor that in and put it into the equation?

Mr. GREENSPAN. Remember that what we look at is the potential development of an inflationary process which we believe would, if allowed to accelerate, undermine economic growth and, therefore, employment. Because of the efficiency of the American capital markets, there really is only one set of interest rates for the Nation as a whole, and the only thing that we have control of, in part at least, is short-term interest rates because of the Federal funds rate which we can control arbitrages against other short-term rates, and as a consequence we sometimes affect the longer-term rates, but only because—as the impact of short-term rates filters out into longer-term rates.

What we cannot do is affect interest rates in individual areas of the country. We used to be able to do that years ago. We cannot anymore, and we are situated in a manner where we cannot readily affect the distribution of incomes or the distribution of employment nationwide because we only have one instrument with which we deal, and as a consequence monetary policy per se cannot very readily impact on individual areas within cities or rural areas.

What we do tend to do is to try through other aspects of the Federal Reserve System, our Federal Reserve Banks and branches' community affairs divisions, for example, to try to work with individual groups to try to involve them and ourselves in a manner to try, as I indicated earlier to one of your colleagues, to see if we can get equity capital or debt capital or means of financing which could be of assistance.

But as far as monetary policy is concerned, we have one tool for one market, and all we can do is try to attain, as I indicated before, our ultimate goal, which we perceive to be maximum sustainable growth for the economy as a whole. We don't have the instruments in monetary policy to go beyond that.

Mr. WATT. Thank you, Mr. Chairman.

Chairman CASTLE. Thank you, Mr. Watt.

Mr. Bachus has waited patiently.

Mr. BACHUS. Thank you.

Chairman Greenspan, I was looking at your testimony from March 8th of 1995, where you described the budget deficit as putting upward pressure on interest rates, especially nominal rates, and that it also tends to be inflationary. And I would suppose, first of all, that the converse is true; is it not?

Mr. GREENSPAN. Yes it is. In fact, it is quite symmetrical in that regard.

Mr. BACHUS. Now, Chairman Castle mentioned to you tax cuts, and he said we are now in a surplus. Being in a surplus, and we are in a surplus, but whether or not it is transitory, do you think it is having an effect on the economy now?

Mr. GREENSPAN. Indeed I think it is. Long-term interest rates, I suspect, are significantly lower than they would have been, for example, if we continued with that $200 billion deficits, and to the extent that that is the case, interest-sensitive areas of the economy have prospered to the extent they would not have if we had those large deficits.

Mr. BACHUS. If we continue to have a surplus, would you continue to think it would be an influencing factor on lowering interest rates?

Mr. GREENSPAN. Yes, I do. One of the reasons why I have argued that we shouldn't be hasty in trying to find uses for the surplus is that the surplus is doing an awful lot of good. It is basically reducing outstanding public debt, reducing interest costs to the Treasury, and increasing the surplus even more as a consequence. But the overall effect of large surplus is to increase national saving, reduce long-term interest rates, and create positive add-ons to the economy.

Mr. BACHUS. You know, you have talked about how you can influence the Fed fund rate, and you talked about an orientation right now toward preventing inflation as opposed to reducing interest rates; that is, your primary concern is inflation. If we are in a surplus, and if it has taken off some of the inflationary pressure, in making interest rate policy decisions, do you consider that we are in a surplus now? Is that something that you are factoring in?

Mr. GREENSPAN. The way we determine monetary policy is to look at the development, as I indicated before, of potential inflationary or deflationary processes to which we respond one way or the other. It is our judgment based on evaluation of the effect of budget deficit on the economy that the emerging surplus, and indeed we have had one now for a number of months, is acting in a positive manner keeping down inflationary pressures, which means that less is required on the part of monetary policy.

Mr. BACHUS. So, as it continues, it is something that is a factor that you consider in setting a Fed fund rate?

Mr. GREENSPAN. Well, we don't consider——

Mr. BACHUS. Or in setting monetary policy?

Mr. GREENSPAN. We don't consider it directly, but what we do is recognize that because it impacts the economy overall, and we respond to the economy directly, the answer is clearly it does have an effect on how the central bank behaves.

Mr. BACHUS. Back on March 8, 1995, you said that you think one of the first things that is likely to happen if we do get a budget surplus is that long-term interest rates will fall significantly. I will tell you as a Member of Congress that the budget is balanced now, and we are looking to see those long-term rates——

Mr. GREENSPAN. Well, they are. They are significantly below where they were back then. So, in fact, we have had long-term interest rates down quite considerably since 1993.

Mr. BACHUS. The surplus has only been in effect for the last——

Mr. GREENSPAN. That is true, but remember that it is the reduction in the deficit as it moves into surplus that is relevant. There is no magic point which is—when you go into surplus, all of a sudden something happens. It is a continuum. Just reducing the deficit has the same effect as eventually just getting into surpluses.

Mr. BACHUS. Thank you.

Now, let me ask one other question, and this is totally switching gears, but we have talked about the terrible problem in the world community now with Japan, Asia, Russia and whether or not Russia will fall, whether or not Japan will pull out of its dive. I would simply ask you if you would like to comment on this.

The debate in Congress seems to be, will Russia fall, will Japan pull out of its dive characterizes whether we lend them money and how much. And I would submit to you at least my view is that whether or not Russia falls, whether or not Japan pulls out is dependent not on whether we lend them money or not, or how much, but how much they reform their systems.

Mr. GREENSPAN. Absolutely. I agree with that. The issue of lending the money is only useful if it is a transitional bridge to assist them in reforming their economies. If they don't reform their economies, I don't care how much you lend them, it is not going to help.

Mr. BACHUS. And I think what some of us who have advocated withholding money, insist on policy changes, and then the money will come.

Now, you have talked about a fire, but, in Russia for two or three years now they have not upheld the U.N. sanctions against Iraq; they have cooperated with Iran, which promotes international terrorism; they have taken a course of action which leads to proliferation of weapons of mass destruction. And I think what some of us have said is we want to see a policy change. I would say to you that the proliferation of weapons of mass destruction is probably more harmful to our economy than a Russian nose dive.

Mr. GREENSPAN. That is the judgment which the Congress is employed to make, tough tradeoffs that you have to be involved with.

Mr. BACHUS. And I am not sure, do you consider when you say we should lend Russia money, you have come——

Mr. GREENSPAN. I am not saying we should loan Russia. I am just saying we should replenish the IMF.

Chairman CASTLE. Mr. Bachus, can you ask a final question?

Mr. BACHUS. Yes. I guess when you say that—do you make foreign policy considerations?

Mr. GREENSPAN. No. I just make them on the grounds of the issue of international financial stability and how it affects us.

Mr. BACHUS. And you understand there are other factors.

Mr. GREENSPAN. Certainly, of course.

Mr. BACHUS. Thanks.

Chairman CASTLE. Thank you very much. We appreciate it.

Mr. Hinchey.

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

On the issue of long-term interest rates, I find myself, of course, agreeing with Mr. Bachus' line of questioning just a few moments ago. I anticipated that real interest rates would be coming down as the budget deficit was erased and as we moved into a period of surplus and am equally disappointed that we haven't seen that happen. I hope that it will not take a serious downturn in the economy in order to press the Federal Reserve into doing something about real interest rates.

Perhaps the most interesting debates that we have had on this subcommittee since I have been a Member is the efficacy of Humphrey-Hawkins in its dual responsibilities to promote maximum economic growth while maintaining low inflation, and also the debate that we have had over the course of the last several years on this subcommittee with regard to the level of growth that the economy *could see without triggering an increase in inflation.*

Many of us on this side of the subcommittee have argued that we could see substantially higher rates of growth beginning back in 1993 in the present context without triggering inflation, and indeed history has borne that out. We have seen the economy grow very substantially over the last five years, and inflation, if anything, has declined during that time and continues to do so now. However, there are some very dangerous things that we see abroad that do not bode well for our economy at home.

The National Association of Purchasing Managers' Index shows that manufacturing actually began to fall last month. There is a deepening decline in export orders. The export index fell, as a matter of fact, last month for the sixth consecutive month. The trade deficit and other factors have resulted in a decline in factory jobs. We lost 29,000 of these jobs just last month. Perhaps we may see bigger declines in factory jobs ahead. There is a reduction in the economic growth and a reduction in wage pressure. Trade deficit in goods alone for May was a little over $21.5 billion.

So there are indications that we are going to see a sharp decline in growth ahead, largely attributed to the financial crisis in Asia. I wonder what you think about all of those factors in concert, Mr. Chairman, and what we might do, both in terms of monetary and fiscal policy to, in effect, gird our loins against this onslaught, which is so apparent and indeed increasingly palpable.

Mr. GREENSPAN. Obviously we are looking at the same data base that you are referring to, and one of the reasons why we have argued that we thought the rate of growth would slow down to a sustainable pace which would not be destabilizing is that we expect the Asian internationally-related events to be of a nature which would slow growth in the United States, which it has, as far as we can judge.

The issue of forecasting how far it will go is exceptionally difficult to do. I have been in the forecasting business for 50 years, and I know when I can forecast something reasonably well and not. This is a tough one. It is an exceptionally difficult one to make projections about, which is the reason we spend so much time day by day just trying to evaluate what is going on and try to be prepared as best we can for events altering in a manner which we did not anticipate. So far it has not reached a stage that the Chairman characterized in his opening remarks, but we recognize that there has been no evidence of stability yet. Contagion is still there. Latin America has held up better than we would have expected at certain occasions. Southeast Asia has turned out to be worse than we had expected. But all of these pieces have to fit together in an overall policy framework, and that is what we try to do, and we try to come to an appropriate balance.

It is certainly the case that inflation has come down in recent years. It is an interesting issue as to whether, had we not, when we had the big underlying cost pressures in 1994, engaged in some tightening to cutoff the top of what we saw was a bulging inflationary set of forces, whether we would have ended up with as benign an outlook as apparently emerged in the last two or three years.

Let me say with respect to real interest rates, real interest rates have actually been declining in the long end of the market in the last couple of years. To be sure, they have risen in the short end because we have kept the funds rate constant, and inflation expectations have doubtless been declining.

But the ultimate determination as to whether or not interest rates are containing or expanding the economy can only be judged by looking at the economy itself, and we see that interest-sensitive areas of the economy, such as housing and motor vehicles, have been actually quite strong. If monetary policy were exceptionally restrictive at this stage, or even mildly restrictive, it is very hard to make the case that housing starts, for example, would be as buoyant as they have been, and motor vehicle sales as strong as they have been.

So while it is certainly the case that short-term real interest rates have risen, it is quite conceivable that the falling long-term real rates has more than offset that, but either way we have not yet seen any constrictive elements within the domestic economy as a consequence of monetary policy. Obviously, to the extent that we do see that or the potential of that occurring, that will affect what our policy is, as it should.

Mr. HINCHEY. If I can have one more?

Chairman CASTLE. Very briefly. We are running quite late here.

Mr. HINCHEY. I appreciate your sensitivity to that, Mr. Chairman. I don't pretend to have any impact on your philosophy or your thought process, but I appreciate your sensitivity to this situation.

My concern is simply this: Real wages for real workers have recently begun to go up, and they were stagnant for a long, long time, and there was a lot of unrest in this country, and appropriately so, because of the fact that people were working harder and longer and not getting ahead. They have begun to see some progress recently.

I am deeply fearful that if we do not act appropriately, that the present problems that we are facing, largely originating in Asia, are going to have an impact on those people who have just now begun to enjoy the fruits of this growing economy. So whatever we can do to continue to assure that working people who work for wages particularly get the benefits of this economy, the better off we are all going to be in the long run.

Mr. GREENSPAN. I agree with that.

Chairman CASTLE. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman Greenspan, I apologize for having to leave during the early part of the questioning for some debate on the House floor. I have a number of questions, a number of which I will, of course, have to submit for the record, because I have got as much chance of getting an answer to all them as winning the lottery in the amount of time that I have. But let me ask one very quickly.

With respect to the IMF, the House Majority Leader Dick Armey has stated, and I will paraphrase him, that he sees no reason to support policies of the IMF which are counterproductive. Is it your opinion that the policies the IMF and the G-7 have imposed on the Asian countries, specifically South Korea, Thailand, Indonesia, that those are counterproductive, or do you think those are productive policies?

Mr. GREENSPAN. Some of them probably were mistaken in the early stages, but I would say, overall the policies, I think, have probably been positive.

Mr. BENTSEN. Particularly since, say, the Christmas period or——

Mr. GREENSPAN. In other words, there were a couple of false starts, and I would certainly scarcely give them an A, but I wouldn't give our policies As either in many areas, so that it is not an issue of do they always do exactly the right thing? I think not. But overall they have been a force mainly for good rather than evil, if I may put it into moral terms that the Chairman of the committee was putting it in. We are better off having done what has been done there, especially with endeavoring to contain monetary growth and monetary base expansion in a lot of these areas, than where there are no such facilities available.

Mr. BENTSEN. Thank you.

My next question goes to what the Chairman of the subcommittee raised and my colleague from Alabama raised with respect to the unified budget surplus, and you, I think appropriately, point out that nonetheless there is still a $5.4 trillion debt outstanding. If you look at the figures, our debt-to-GDP ratio, and we have had this discussion before, has doubled since 1981, and our interest on the debt as a percentage of GDP has increased as well since 1981 to about 3 percent of GDP.

Now, I think what you said was that you would prefer us paying down the debt, but if we were to break the virtuous cycle of the spending discipline or budget discipline we have had in the last few years, that you would prefer tax cuts to spending. I assume, because you would believe that, while both are a form of consumption, tax cuts may well be more efficient than Government spending.

My first question is is that correct, but my main question is this: Wouldn't it be a mistake for us not to use this windfall that we may or may not have of $1.5 trillion over ten years—and you are right, we don't know if it is going to stay at that—to pay down the debt, which, in effect, would be more of an investment nature than a consumption nature, and can't we look at previous history and see that consumption, whether for spending or for tax cuts, does carry a price, and that price being the additional interest costs that we have had to pay if you look at just the 1981 to 1998 cycle? And would you feel that any change in the spending caps or in the revenue side which breaches the budget discipline we have had would have a negative market reaction as well?

Mr. GREENSPAN. It may well incidentally. My concern is that if you look at our commitments into the future that are currently embodied in the law, that the stability of the system, unless we get very major continued improvements in revenues, is in doubt. In other words, long-term CBO and OMB projections over the years have indicated that we are going to have to adjust, for example, Social Security. There are questions about outlay growth implied in the aging of the population more generally, which includes both Medicare and Social Security, and whether or not we have the real resources to meet those commitments. And what has happened in the last two or three years is a big bulge in receipts, the source of which is not altogether clear.

And so my concern is that we commit further to new, various different type of entitlement programs which will make the situation worse, not better, if it turns out that the presumed receipts are really ephemeral, and that as I indicated earlier, the Japanese experience, where when they have this huge increase in asset values, the ratio of their tax receipts to nominal income rose significantly, and when it turned around, they reversed, and what I am not at all convinced of at this particular stage is that those very large surpluses which we are calculating are real, and I would be very concerned if we committed them on the expenditure side because I think it would be difficult to reverse. I think there is less danger on the tax side.

Mr. BENTSEN. Thank you.

Chairman CASTLE. Mr. Bentsen, this will be the final point.

Mr. BENTSEN. I appreciate that, but nonetheless could you quantitatively state that whether it is expenditure or on the tax side, it would be better to put it on the investment side in retiring debt rather than either expenditure or tax reduction?

Mr. GREENSPAN. Yes. My first choice is to retire debt as much as we can because it has a positive economic impact, and in the event that some of this expected surplus is indeed ephemeral, it doesn't create a particular problem for us. But if we commit something which we are not sure we have, we are taking a risk. As I said in the Senate yesterday, if it turns out that it is just not possible to keep surpluses of these orders of magnitude without using them one form or another, I would very much be inclined to cut taxes than to put them into expenditure programs, because over the long run it is easier to get fiscal stability if your expenditure numbers are not escalating at a pace in excess of nominal income or nominal taxable base of the society.

Mr. BENTSEN. And it is easier to change the revenue side than the entitlement side.

Mr. GREENSPAN. Far easier too.

Chairman CASTLE. Thank you, Mr. Bentsen.

And, Chairman Greenspan, we thank you. It is as always a fairly exhaustive period of time that we go through this, but hopefully the questions that need to be asked were asked, and the answers that you should provide were provided, and we appreciate it, and we appreciate your continuing good work. We need you to go back in the field and make sure the stock market goes up before the end of the day.

Mr. GREENSPAN. Yes, sir.

[Whereupon, at 12:53 p.m., the hearing was adjourned.]

APPENDIX

July 22, 1998

House Committee on Banking and Financial Services
Subcommittee on Domestic and International Monetary policy
Humphrey-Hawkins Hearing with testimony from Federal Reserve Board
Chairman Alan Greenspan,
10:00 a.m., July 22, 1998
Room 2128 Rayburn House Office Building

Chairman Michael N. Castle's Opening Remarks:

The Subcommittee will come to order.

The Subcommittee meets today, to receive the annual mid-year report of the **Board of Governors of the Federal Reserve System on the conduct of monetary policy and the state of the economy, as mandated in the Full Employment and Balanced Growth Act of 1978.**

Chairman Greenspan, welcome back to the House Committee on Banking and Financial Services, Subcommittee on Domestic and International Monetary Policy. The American economy continues to perform well, due in part to the work of the Federal Reserve. We are not greedy, but we would be very grateful if you could just announce that the current good economic times will continue for at least another 88 months.

When the Humphrey Hawkins Act was passed in 1978, the target rate of 4% unemployment seemed like an unrealistic fantasy, since everyone knew that full employment was defined as an unemployment rate of about six percent. Today the 4% rate seems almost in reach and some argue that the second quarter of this year will prove to have actually been a period of deflation.

When you last visited us in February, we discussed our concerns over the troubled Japanese economy. The change in the Government of Japan confirms that those concerns were valid. The Asian economic uncertainty, and especially the status of Japan's economy, are almost certainly the greatest threat to our own economic health. I hope that you will share with us your impressions regarding the degree of seriousness with which the Japanese authorities are approaching the solution of their economic problems.

The rest of Asia still is in the process of digging out from their own problems and success depends heavily on Japan. The danger of spreading this international economic flu seems even more real when we watch the situation in Russia. If oil prices continue to hover around their current low levels Mexico may again be in crisis and others in Latin America could follow. We hope you will comment on the dangers of the regional economic problems reinforcing each other and what they mean for the world economy.

As you know, the debate rages on in Congress over whether the United States should contribute an additional $18 billion to the International Monetary Fund to help meet international economic instability and I am very eager to hear your views on the role of the IMF in addressing these problems.

While we look to you to alert us to what we should be worrying about, we also expect that when you address the House, the markets will move up-- as opposed to occasions when you address the Senate.

The high relative value of the dollar evidently continues to reflect both the leading position of our economy with regard to Europe and the Far East, and the capital that arrives from areas suffering economic insecurity. Should we anticipate further action such as the June 17th intervention to prop up the Yen?

As a general rule is this an effective strategy?

As the economy continues to rewrite the traditional economic models, we would welcome your insights regarding adjustments being incorporated into your models.

My view is that we must have *a full discussion of the potential impact of* events in Japan and Asia on the future of our own economy and working Americans, and what steps we, as policy makers can take to protect our nation.

As always, we are delighted to have you with us and look forward to a lively discussion.

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to present the Federal Reserve's midyear report on monetary policy.

Overall, the performance of the U.S. economy continues to be impressive. Over the first part of the year, we experienced further gains in output and employment, subdued prices, and moderate long-term interest rates. Important crosscurrents, however, have been impacting the economy. With labor markets very tight and domestic final demand retaining considerable momentum, the risks of a pickup in inflation remain significant. But inventory investment, which was quite rapid late last year and early this year, appears to have slowed, perhaps appreciably. Moreover, the economic and financial troubles in Asian economies are now demonstrably restraining demands for U.S. goods and services--and those troubles could intensify and spread further. Weighing these forces, the Federal Open Market Committee chose to keep the stance of policy unchanged over the first half of 1998. However, should pressures on labor resources begin to show through more impressively in cost increases, policy action may need to counter any associated tendency for prices to accelerate before it undermines this extraordinary expansion.

Recent Developments

When I appeared before your subcommittee in February, I noted that a key question for monetary policy was whether the consequences of the turmoil in Asia would be sufficient to check inflationary tendencies that might otherwise result from the strength of domestic spending and tightening labor markets. After the economy's surge in 1996 and, especially, last year, resource utilization, particularly that of the labor force, had risen to a very high level. Although some signs pointed to stepped-up increases in productivity, the speed at which the demand for goods and services had been growing clearly exceeded the rate of expansion of the economy's long-run potential to produce. Maintenance of such a pace would put even greater pressures on the economy's resources, threatening the balance and longevity of the expansion.

However, it appeared likely that the difficulties being encountered by Asian economies, by cutting into U.S. exports, would be a potentially important factor slowing the growth of aggregate demand in the United States. But uncertainties about the timing and dimensions of that development were considerable given the difficulties in assessing the extent of the problems in East Asia.

In the event, the contraction of output and incomes in a number of Asian economies has turned out to be more substantial than most had anticipated. Moreover, financial markets in Asia and in emerging market economies generally have remained unsettled, portending further difficult adjustments. The contraction in Asian economies, along with the rise in the foreign exchange value of the dollar over 1997, prompted a sharp deterioration in the U.S. balance of trade in the first quarter. Nonetheless, the American economy proved to be unexpectedly robust in that period. The growth of real GDP not only failed to slow, it climbed further, to about a 5½ percent annual rate in the first quarter, according to the current national income accounts. Domestic private demand for goods and services---including personal consumption expenditures, business investment, and residential expenditures---was exceptionally strong.

Evidently, optimism about jobs, incomes, and profits, high and rising wealth-to-income ratios, low financing costs, and falling prices for high-tech goods fed the appetites of households and businesses for consumer durables and capital equipment. In addition, inventory investment contributed significantly to growth in the first quarter; indeed, the growth of stocks of materials and goods outpaced that of overall output by a wide margin during the first quarter, adding 1¾ percentage points to the annualized growth rate of GDP. Although accumulation of some products likely was unintended, surveys indicate that much of the stockbuilding probably reflected firms' confidence in the prospects for continued growth.

As evidence piled up that the economy continued to run hot during the winter, the Federal Reserve's concerns about inflationary pressures mounted. Domestic demand clearly had more underlying momentum than we had anticipated, supported in part by financial conditions that were quite accommodative. Credit remained extremely easy for most borrowers to obtain; intermediate- and long-term interest rates were at relatively low levels; equity prices soared higher, despite some disappointing earnings reports; and growth in the monetary aggregates was rapid. Indeed, the crises in Asia, by lowering longer-term U.S. interest rates--through stronger preferences for dollar investments and expectations of slower growth ahead--and by reducing commodity prices, probably added to the positive forces boosting domestic spending in the first half, especially in the interest-sensitive housing sector. The robust expansion of demand tightened labor markets further, giving additional impetus to the upward trend in labor costs. Inflation was low--though, given the lags with which monetary policy affects the economy and prices, we had to be mainly concerned not with conditions at the moment but with those likely to prevail many months ahead. In these circumstances, the Federal Open Market Committee elected in March to move to a state of heightened alert against inflation, but left the stance of policy unchanged.

Although national income and product data for the second quarter have not yet been published, growth of U.S. output appears to have slowed sharply. The auto strike has brought General Motor's production essentially to a halt, probably reducing real GDP in the second quarter by about ½ percentage point at an annual rate. The limited available information on inventory investment suggests that stockbuilding dropped markedly from its unsustainable pace of the first quarter. In addition to the slower pace of inventory building, Asian economies have continued to deteriorate, further retarding our exports in recent months.

Indeed, readings on the elements that make up the real GDP have led many analysts to anticipate a decline in that measure in the second quarter, after the first-quarter surge. Given the upcoming revisions to the national income accounts, such assessments would have to be regarded as conjectural. It is worth noting in any case that other indicators of output, including worker hours and manufacturing production, show a somewhat steadier, though slowing, path over the first half of the year. And underlying trends in domestic final demand have remained strong, imparting impetus to the continuing economic expansion.

During the first half of the year, measures of resource utilization diverged. Pressures on manufacturing facilities appeared to be easing. Plant capacity was growing rapidly as a result of vigorous investment. And growth of industrial output was dropping off from its brisk pace of 1997, importantly reflecting the deceleration in world demand for manufactured goods that resulted from the Asian economic difficulties.

But labor markets, in contrast, became increasingly taut during the first half. Total payroll jobs rose about one-and-one-half million over the first six months of the year. The civilian unemployment rate dropped to a bit below 4½ percent in the second quarter, its lowest level in three decades. Firms resorted to a variety of tactics to attract and retain workers, such as paying various types of monetary bonuses and raising basic wage rates. But, at least through the first quarter, the effects of a rising wage bill on production costs were moderated by strong gains in productivity.

Indeed, inflation stayed remarkably damped during the first quarter. The consumer price index as well as broader measures of prices indicate that inflation moved down further, even as the economy strengthened. Although declining oil prices contributed to this development, pricing leverage in the goods-producing sector more generally was held in check by reduced demand from Asia that, among other things, has led to a softening of commodity prices, a strong dollar that has contributed to bargain prices on many imports, and rising industrial capacity. Service price inflation, less influenced by international events, has remained steady at about a 3 percent rate since before the beginning of the crisis.

Some elements in the goods price mix clearly were transitory. Indeed, the more recent price data suggest that overall consumer price inflation moved up in the second quarter. But, even so, the increase remained moderate.

In any event, it would be a mistake for monetary policy makers to focus on any single index in gauging inflation pressures in the economy. Although much public attention is directed to the CPI, the Federal Reserve monitors a wide variety of aggregate price measures. Each is designed for a particular purpose and has its own strengths and weaknesses. Price pressures appear especially absent in some of the measures in the national income accounts, which are available through the first quarter. The chain-weight price index for personal consumption expenditures excluding food and energy, for example, rose 1.5 percent over the year ending in the first quarter, considerably less than the 2.3 percent rise in the core CPI over the same period. An even broader price measure, that for overall GDP, rose 1.4 percent. These indexes, while certainly subject to many of the measurement difficulties the Bureau of Labor Statistics has been grappling with in the CPI, have the advantages that their chain-weighting avoids some aspects of so-called substitution bias and that already published data can be revised to incorporate new information and measurement techniques. Taken together, while the various price indexes show some differences, the basic message is that inflation to date has remained low.

Economic Fundamentals: The Virtuous Cycle

So far this year, our economy has continued to enjoy a virtuous cycle. Evidence of accelerated productivity has been bolstering expectations of future corporate earnings, thereby fueling still further increases in equity values, and the improvements in productivity have been helping to reduce inflation. In the context of subdued price increases and generally supportive credit conditions, rising equity values have provided impetus to spending and, in turn, the expansion of output, employment, and productivity-enhancing capital investment.

The essential precondition for the emergence, and persistence, of this virtuous cycle is arguably the decline in the rate of inflation to near price stability. In recent years, continued low product price inflation and expectations that it will persist have promoted stability in financial markets and fostered perceptions that the degree of risk in the financial outlook has been moving ever lower. These perceptions, in turn, have reduced the extra compensation that investors require for making loans to, or taking ownership positions in, private firms. With risks in the domestic economy judged to be low, credit and equity capital have been readily available for many businesses, fostering strong investment. And low mortgage interest rates have allowed many households to purchase homes and to refinance outstanding debt. The reduction in debt servicing costs has contributed to an apparent stabilization of the financial strains on the household sector that seemed to emerge a couple of years ago and has buoyed consumer demand.

To a considerable extent, investors seem to be expecting that low inflation and stronger productivity growth will allow the extraordinary growth of profits to be extended into the distant future. Indeed, expectations of earnings growth over the longer term have been undergoing continual upward revision by security analysts since early 1995. These rising expectations have, in turn, driven stock prices sharply higher and credit spreads lower, perhaps in both cases to levels that will be difficult to sustain unless the virtuous cycle continues. In any event, primarily because of the rise in stock prices, about $12½ trillion has been added to the value of household assets since the end of 1994. Probably only a few percent of these largely unrealized capital gains have been transformed into the purchase of goods and services in consumer markets. But that increment to spending, combined with the sharp increase in equipment investment, which has stemmed from the low cost of both equity and debt relative to expected profits on capital, has been instrumental in propelling the economy forward.

The consequences for the American worker have been dramatic and, for the most part, highly favorable. A great many chronically underemployed people have been given the opportunity to work, and many others have been able to upgrade their skills as a result of work experience, extensive increases in on-the-job training, or increased enrollment in technical programs in community colleges and elsewhere. In addition, former welfare recipients appear to have been absorbed into the work force in significant numbers.

Government finances have been enhanced as well. Widespread improvement has been evident in the financial positions of state and local governments. In the federal sector, the taxes paid on huge realized capital gains and other incomes related to stock market advances, coupled with taxes on markedly higher corporate profits, have joined with restraint on spending to produce a unified budget surplus for the first time in nearly three decades. The important steps taken by the Congress and the Administration to put federal finances on a sounder footing have added to national saving, relieving pressures on credit markets. The paydown of debt associated with the federal surplus has helped to hold down longer-term interest rates, which in turn has encouraged capital formation and reduced debt burdens. Maintaining this disciplined budget stance would be most helpful in supporting a continuation of our current robust economic performance in the years ahead.

The fact that economic performance has strengthened as inflation subsided should not have been surprising, given that risk premiums and economic disincentives to invest in productive capital diminish as the economy approaches price stability. But the extent to which strong growth and high labor force utilization have been joined with low inflation over an extended period is, nevertheless, exceptional. So far, at least, the adverse wage-price interactions that played so central a role in pressuring inflation higher in many past business expansions---eventually bringing those expansions to an end---have not played a significant role in the current expansion.

For one thing, increases in hourly compensation have been slower to pick up than in most other recent expansions, although, to be sure, wages have started to accelerate in the past couple of years as the labor market has become progressively tighter. In the first few years of the expansion, the subdued rate of rise in hourly compensation seemed to be, in part, a reflection of greater concerns among workers about job security. We now seem to have moved beyond that phase of especially acute concern, though the flux of technology may still be leaving many workers with fears of job skill obsolescence and a willingness to trade wage gains for job security. In the past couple of years, of course, workers have not had to press especially hard for nominal pay gains to realize sizable increases in their real wages. In contrast to the pattern that developed in several previous business expansions, when workers required substantial increases in pay just to cover increases in the cost of living, consumer prices have been generally well-behaved in the current expansion.

A couple of years ago--almost at the same time that increases in total hourly compensation began trending up in nominal terms--evidence of a long-awaited pickup in the growth of labor productivity began to show through more strongly in the data; and this accelerated increase in output per hour has enabled firms to raise workers' real wages while holding the line on price increases. Gains in productivity usually vary with the strength of the economy, and the favorable results that we have observed during the past two years or so, when the economy has been growing more rapidly, almost certainly overstate the degree of structural improvement. But evidence continues to mount that the trend of productivity has accelerated, even if the extent of that pickup is as yet unclear. Signs of major technological improvements are all around us, and the benefits are evident not only in high-tech industries but also in production processes that have long been part of our industrial economy.

Those technological innovations and the rapidly declining cost of capital equipment that embodies them in turn seem to be a major factor behind the recent enlarged gains in productivity. Evidently, plant managers who were involved in planning capital investments anticipated that a significant increase in the real rates of return on facilities could be achieved by exploiting emerging new technologies. If that had been a mistake on their part, one would have expected capital investment to run up briefly and then start down again when the lower-than-anticipated rates of return developed. But we have instead seen sustained gains in investment, indicating that hoped-for rates of return apparently have been realized.

Notwithstanding a reasonably optimistic interpretation of the recent productivity numbers, it would not be prudent to assume that even strongly rising productivity, by itself, can ensure a non-inflationary future. Certainly wage increases, per se, are not inflationary, unless they exceed productivity growth, thereby creating pressure for inflationary price increases that can eventually undermine economic growth and employment. Because the level of productivity is tied to an important degree to the stock of capital, which turns over only gradually, increases in the trend growth of productivity probably also occur rather gradually. By contrast, the potential for abrupt acceleration of nominal hourly compensation is surely greater.

As I have noted in previous appearances before Congress, economic growth at rates experienced on average over the past several years would eventually run into constraints as the reservoir of unemployed people available to work is drawn down. The annual increase in the working-age population (from 16 to 64 years of age), including immigrants, has been approximately 1 percent a year in recent years. Yet employment, measured by the count of persons who are working rather than by the count of jobs, has been rising 2 percent a year since 1995, despite the acceleration in the growth of output per hour. The gap between employment growth and population growth, amounting to about 1.1 million persons a year on average since the end of 1995, has been made up, in part, by a decline in the number of individuals who are counted as unemployed--those persons who are actively seeking work--of approximately 650,000 a year, on average, over the past two and one-half years. The remainder of the gap has reflected a rise in labor force participation that can be traced largely to a decline of almost 300,000 a year in the number of individuals (aged 16 to 64) wanting a job but not actively seeking one.

Presumably, many of the persons who once were in this group have more recently become active and successful job-seekers as the economy has strengthened, thereby preventing a still sharper drop in the official unemployment rate. In June, the number of persons aged 16 to 64 who wanted to work but who did not have jobs was 10.6 million on a seasonally adjusted basis, roughly 6 percent of the working-age population. Despite an uptick in joblessness in June, this percentage is only fractionally above the record low reached in May for these data, which can be calculated back to 1970.

Nonetheless, a strong signal of inflation pressures building because of compensation increases markedly in excess of productivity gains has not yet clearly emerged in this expansion. Among nonfinancial corporations (our most recent source of data on consolidated income statements), trends in costs seem to have accelerated from their lows, but the rates of increase in both unit labor costs and total unit costs are still quite low.

Still, the gap between the growth in employment and that of the working-age population will inevitably close. What is crucial to sustaining this unprecedented period of prosperity is that it close reasonably promptly, given already stretched labor resources, and that labor markets find a balance consistent with sustained growth marked by compensation gains in line with productivity advances. Whether these adjustments will occur without monetary policy action remains an open question.

Foreign Developments

While the United States has been benefiting from a virtuous economic cycle, a number of other economies unfortunately have been spiraling in quite the opposite direction. The United States, Canada, and Western Europe have been enjoying solid economic growth, with relatively low inflation and declining unemployment, but the economic performance in many developing and transition nations and Japan has been deteriorating. How quickly the latter erosion is arrested and reversed will be a key factor in shaping U.S. economic and financial trends in the period ahead. With all that is at stake, it would be difficult to overstate how crucial it is that the authorities in the relevant economies promptly implement effective policies to correct the structural problems underlying recent weaknesses and to promote sustainable economic growth before patterns of reinforcing contraction become difficult to contain.

Conditions in Asia are of particular concern. Aggregate output of the Asian developing economies has plunged, with particularly steep declines in Korea, Malaysia, Thailand, and Indonesia. Even the economies of the stalwart tigers--Hong Kong, Singapore, and Taiwan--have softened. Economic growth in China has also slowed, owing largely to the currency depreciations among its neighbors and the sharp declines in their demand for imports.

Russia has also experienced some spillover from the Asian difficulties, but Russia's problems are mostly homegrown. Large fiscal deficits stem from high effective marginal tax rates that encourage avoidance and do not raise adequate revenue. This and the recent declines in prices of oil and other commodities have rendered Russian financial markets and the ruble vulnerable, particularly in an environment of heightened concern about all emerging markets. The Russian government has recently promulgated a set of new policy measures in connection with an expanded IMF support package in an effort to address these problems.

In Latin America, conditions vary: Economies that are heavily dependent on exports of oil and other commodities have suffered as prices of those items have fallen, and several countries in that region have received more intensive scrutiny in international capital markets, but, on the whole, Latin American economies continue to perform reasonably well.

Disappointingly, economic activity in Japan---a crucial engine of Asian economic growth---has turned down after a long period of subpar growth. Gross domestic product fell at a 5¼ percent annual rate in the first quarter. More recently, confidence of households and businesses has continued to erode, the sharp contraction elsewhere in Asia has fed back onto Japan, and the dwindling domestic demand for goods and services in that country has been further constrained by a mounting credit crunch. Nonperforming loans have risen sharply as real estate values fell following the bursting of the asset bubble in 1991. Problems in the banking sector, exacerbated by the broader Asian financial crisis, have led to market concerns about the adequacy of the capital of many

Japanese banks and have engendered a premium in the market for Japanese banks' borrowing. This resulting squeeze to profit margins has led to a reluctance to lend in dollars or yen. *In response to the weakening economy and deteriorating banking* situation, the Japanese yen has tended to weaken significantly, in often-volatile markets, against the dollar and major European currencies.

As you know, we have sought to be helpful in the Japanese government's efforts to stabilize their economy and financial system, reflecting our awareness of the important role that Japanese financial and economic performance plays in the world economy, including that of the United States. We have consulted with the relevant Japanese authorities on methods for resolving difficulties in their banking system and have urged them to take effective measures to stimulate their economy. I believe that the Japanese authorities recognize the urgency of the situation.

That a number of foreign economies are currently experiencing difficulties is not surprising. Although many had previously realized a substantial measure of success in developing their economies, a number had leaned heavily on command-type systems rather than relying primarily on market mechanisms. This characteristic has been evident not only in their industrial sectors but in banking where government intervention is typically heavy, where long-standing personal and corporate relationships are the predominant factor in financing arrangements, and where market-based credit assessments are the exception rather than the rule. Recent events confirm that these sorts of structures are ill-suited to today's dynamic global economy, in which national economies must be capable of adapting flexibly and rapidly to changing conditions.

Responses in countries currently experiencing difficulties have varied considerably. Some have reacted quickly and, in general terms, appropriately. But in others, a variety of political considerations appear to have militated against prompt and effective action.

As a consequence, the risks of further adverse developments in these economies remain substantial. And given the pervasive interconnections of virtually all economies and financial systems in the world today, the associated uncertainties for the United States and other developed economies remain substantial as well.

In the current circumstances, we need to be aware that monetary policy tightening actions in the United States could have outsized effects on very sensitive financial markets in Asia, a development that could have substantial adverse repercussions on U.S. financial markets and, over time, on our own economy. But while we must take account of such foreign interactions, we must be careful that our responses ultimately are consistent with a monetary policy aimed at optimal performance of the U.S. economy. Our objectives relate to domestic economic performance, and price stability and maximum sustainable economic growth here at home would best serve the long-run interests of troubled financial markets and economies abroad.

The Economic Outlook

The Federal Open Market Committee believes that the conditions for continued growth with low inflation are in place here in the United States. As I noted previously, an important issue for policy is how the imbalance of recent years between the demand for labor and the growth of the working-age population is resolved. In that regard, we see a slowing in the growth of aggregate demand as a necessary element in the mix.

At this time, some of the key factors that have supported strong final demand by domestic purchasers remain favorable. Although real short-term interest rates have risen as the federal funds rate has been held unchanged while inflation expectations have declined, the financial conditions that have fostered the strength in demand are still in place. With their incomes and wealth having been on a strong upward track, American consumers remain quite upbeat. For businesses, decreasing costs of and high rates of return on investment, as well as the scarcity of labor, could keep capital spending elevated. These factors suggest some risk that the labor market could get even tighter. And even if it does not, under prevailing tight labor markets increasingly confident workers might place gradually escalating pressures on wages and costs, which would eventually feed through to prices.

But a number of factors likely will serve to damp growth in aggregate demand, helping to foster a reasonably smooth transition to a more sustainable rate of growth and reasonable balance in labor markets. We have yet to see the full effects of the crisis in

East Asia on U.S. employment and income. Residential and business fixed investment already have reached such high levels that further gains approaching those experienced recently would imply very rapid growth of the stocks of housing and plant and equipment relative to income trends. Moreover, business investment will be damped if recent indications of a narrowing in domestic operating profit margins prompt a reassessment of the expected rates of return on investment in plant and equipment. Reduced prospects for the return to capital would not only affect investment directly but could also affect consumption if stock prices adjust to a less optimistic view of earnings prospects.

Of course, the demand for labor that is consistent with a particular rate of output growth also could be lowered if productivity growth were to increase more. And, on the supply side of the labor market, faster growth of the labor force could emerge as the result of increased immigration or delayed retirements. Nonetheless, it appears most probable that the necessary slower absorption of labor into employment will reflect, in part, a deceleration of output growth, as a consequence of evolving market forces. Failing that, firming actions on the part of the Federal Reserve may be necessary to ensure a track of expansion that is capable of being sustained.

Thus, members of the Board of Governors and presidents of the Federal Reserve Banks anticipate a slowing in the rate of economic growth. The central tendency of their forecasts is that real GDP will rise 3 to 3¼ percent over 1998 as a whole and 2 to 2½ percent in 1999. With the rise in the demand for workers coming into line with that of the labor force, the unemployment rate is expected to change little from its current level, finishing next year in the neighborhood of 4½ to 4¾ percent.

Inflation performance will be affected by developments abroad as well as those here at home. The extent and pace of recovery of Asian economies currently experiencing a severe downturn will have important implications for prices of energy and other commodities, the strength of the dollar, and competitive conditions on world product markets. Should the situation abroad remain unsettled, these factors would probably continue to contribute to good price performance in the United States in the period ahead. But it is important to recognize that the damping influence of these factors on inflation is mostly temporary. At some point, the dollar will stop rising, foreign demand will begin to recover, and oil and other commodity prices will stop falling and could even back up some. Indeed, a brisk snap-back in foreign economic activity, should that occur, would add, at least temporarily, to price pressures in the United States.

On a more fundamental level, it is the balance of supply and demand in labor and product markets in the United States that will have the greatest effect on inflation rates here. As I noted previously, wage and benefit costs have been remarkably subdued in the current expansion. Nonetheless, an accelerating trend in wages has been apparent for some time.

In addition, a gradual upward tilt in benefit costs has become evident of late. A variety of factors--including the strength of the economy and rising equity values, which have reduced the need for payments into unemployment trust funds and pension plans, and the restructuring of the health care sector--have been working to keep benefit costs in check in this expansion. But, in the medical area at least, the most recent developments suggest that the favorable trend may have run its course. The slowing of price increases for medical services seems to have come to a halt, at least for a time, and, with the cost-saving shift to managed care having been largely completed, the potential for businesses to achieve further savings in that regard appears to be rather limited at this point. There have been a few striking instances this past year of employers boosting outlays for health benefits by substantial amounts.

Given that compensation costs are likely to accelerate at least a little further, productivity trends and profit margins will be key to determining price performance in the period ahead. Whether the recent strong performance of productivity can be extended remains to be seen. It does seem likely that productivity calculated for the entire economy using GDP data weakened in the second quarter. This development clearly owed, at least in some degree, to the deceleration of output in that period. In manufacturing, where our data are better measured, productivity appears still to have registered a solid increase. We will be closely monitoring a variety of indicators to assess how productivity is performing in the months ahead.

Monetary policymakers see the most likely outcome as modestly higher inflation rates in the next one and one-half years. The central tendency of monetary policymakers'

CPI inflation forecasts is for an increase of 1¾ to 2 percent during 1998 and 2 to 2½ percent next year. As noted, the ebbing of the special factors reducing inflation over the past year or so, such as the decline in oil prices, will account for some of this uptick. But the Federal Open Market Committee will need to remain particularly alert to the possibility that more fundamental imbalances are increasing inflationary pressures. The Committee would need to resist vigorously any tendency for an upward trend, which could become embedded in the inflationary process.

The Committee recognizes that significant risks attend the outlook: One is that the impending constraint from domestic labor markets could bind more abruptly than it has to date, intensifying inflation pressures. The other is the potential for further adverse developments abroad, which could reduce the demand for U.S. goods and services more sharply than anticipated and which would thereby ease pressures on labor markets. While we expect that the situation will develop relatively smoothly, the Committee believes that, given the current tightness in labor markets, the potential for accelerating inflation is probably greater than the risk of protracted, excessive weakness in the economy. In any case, it will need to continue to monitor evolving circumstances closely, and adjust the stance of monetary policy as appropriate, in order to help establish conditions consistent with progress towards the Federal Reserve's goals of price stability and maximum sustainable economic growth.

Ranges for Money and Credit Growth

Indeed, recognition of the benefits of low inflation and our commitment to the Federal Reserve's statutory objective of price stability were once again dominant in the Committee's semiannual review of the ranges for the monetary and debt aggregates. The FOMC noted that the behavior of the monetary aggregates had been somewhat more predictable over the past few years than it had been earlier in the 1990s. The rapid growth of M2 and M3 over the first half of the year, which lifted those measures above the upper ends of the target ranges established in February, was consistent with the unexpectedly strong advance in aggregate demand. However, movements in velocity remain difficult to predict.

The FOMC will continue to interpret the monetary ranges as benchmarks for the achievement of price stability under conditions of historically normal velocity behavior. Consistent with that interpretation, the Committee decided to retain the current ranges for the monetary aggregates for 1998, as well as the range for debt, and to carry them over on a provisional basis to next year. Although near-term prospects for velocity behavior are uncertain, the Committee recognizes that monetary growth does appear to provide some information about trends in the economy and inflation. Therefore, we will be carefully evaluating the aggregates, relative both to forecasts and to their ranges, in the context of other readings on other variables in our efforts to promote optimum macroeconomic conditions.

Concluding Comments

As I have stated in previous testimony, the recent economic performance, with its combination of strong growth and low inflation, is as impressive as any I have witnessed in my near half-century of daily observation of the American economy. Although the reasons for this development are complex, our success can be attributed in part to sound economic policy. The Congress and the Administration have successfully balanced the budget and, indeed, achieved a near-term surplus, a development that tends to boost national saving and investment. The Federal Reserve has pursued monetary conditions consistent with maximum sustainable long-run growth by seeking price stability. These policies have helped bring about a healthy macroeconomic environment for productivity-boosting investment and innovation, factors that have lifted living standards for most Americans. The task before us is to maintain disciplined economic policies and thereby contribute to maintaining and extending these gains in the years ahead.

For use at 10:00 a.m., E.D.T.
Tuesday
July 21, 1998

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

July 21, 1998

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 21, 1998

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,

Alan Greenspan, Chairman

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Section 1: Monetary Policy and the Economic Outlook

The U.S. economy posted significant further gains in the first half of 1998. The unemployment rate dropped to its lowest level in nearly thirty years, and inflation remained subdued. Real output rose appreciably, on balance, although much of the advance apparently occurred early in the year. Household spending and business fixed investment, supported by the ongoing rise in equity prices and the continued low level of long-term interest rates, appear to have maintained considerable momentum this year. The sizable advance in capital spending and the resulting additions to the capital stock should help bolster labor productivity—the key to rising living standards.

Yet the news this year has not been uniformly good. The turmoil that erupted in some Asian countries last year has generated major concerns about the outlook for those economies and the repercussions for other nations, including the United States. Several Asian countries have had sharp contractions in economic activity, and others have experienced distinctly sub-par growth. Heightened uneasiness among international investors has induced portfolio shifts away from Asia and, to some extent, from other emerging market economies.

These difficulties have created considerable uncertainty and risk for the U.S. economy, but they have also helped to contain potential inflationary pressures in the near term by reducing import prices and restraining aggregate demand. In particular, the substantial rise in the foreign exchange value of the dollar has boosted our real imports and—together with the slower growth in Asia—depressed our real exports. At the same time, the runup in the dollar and slack economic conditions in Asia have helped produce a sharp drop in the dollar prices of oil and other commodities and have pushed down other import prices. Shifts in preferences toward dollar-denominated assets in combination with downward revisions to forecasts of inflation and demand have helped to reduce our interest rates; the lower interest rates have boosted household and business spending, offsetting a portion of the damping of demand from the foreign sector.

The Asian crisis is likely to continue to restrain U.S. economic activity in coming quarters. The size of the effect will depend in large part on how quickly the authorities in the Asian nations can put their troubled financial systems on a sounder footing and carry out other essential economic reforms. Deteriorating conditions in many countries during the past few months created added pressures for reform, and they underscored the depth and scope of the problems that must be addressed.

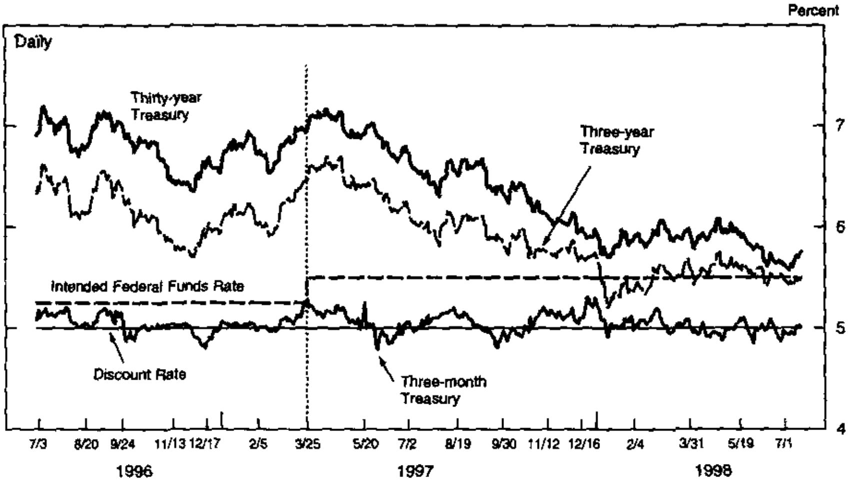
Despite the pronounced weakening of our trade balance, the already tight U.S. labor market has come under further strain this year owing to robust growth of domestic demand. As a result, the outlook for inflation has taken on a greater degree of risk. Consumer prices actually rose a bit less rapidly in the first half of 1998 than they did in 1997, but transitory factors—the drop in oil prices, the runup in the dollar, and weak economic activity in Asia—exerted considerable downward pressure on domestic prices. These factors will not persist indefinitely. Meanwhile, the pool of individuals interested in working but who are not already employed has continued to shrink. The extraordinary tightness in labor markets has generated a rising trend of increases in wages and related costs, although faster productivity growth has damped the effect on business costs so far.

In conducting monetary policy in the first half of 1998, the Federal Open Market Committee (FOMC) closely scrutinized incoming information for signs that the strength of the economy and the taut labor market were likely to boost inflation and threaten the durability of the expansion. However, despite slightly larger increases in the CPI in some months, inflation remained moderate on the whole. Moreover, the Committee expected that aggregate demand would slow appreciably because of a rising trade deficit and a considerable slackening in domestic spending. Although the Committee was acutely aware of the uncertainties in the economic outlook, it believed that the deceleration in demand—and the associated modest easing of pressures on resources—could well be sufficient to limit any deterioration in underlying price performance. On balance, the FOMC chose to keep the intended federal funds rate at 5½ percent.

Monetary Policy, Financial Markets, and the Economy over the First Half of 1998

Output grew rapidly in the first quarter, with real gross domestic product estimated to have risen 5½ percent at an annual rate. Business fixed investment soared after a weak fourth quarter, and consumption and housing expenditures expanded at a strong clip. In addition, contrary to the expectations of many forecasters, inventory investment rose substantially from its already hefty fourth-quarter

Selected Interest Rates



Note. Dotted vertical line indicates the day on which the Federal Open Market Committee (FOMC) announced a monetary policy action. The dates on the horizontal axis are those on which the FOMC held meetings. Last observations are for July 17, 1998.

pace, with the rise contributing more than 1½ percentage points to overall GDP growth. At the same time, the cumulative effect of the appreciation of the dollar and faster growth of demand here than abroad resulted in a sharp drop in real net exports, with both rapid import growth and the first quarterly drop in exports in four years. Employment continued to advance briskly, and the unemployment rate held steady at 4¾ percent. Hourly compensation accelerated somewhat when measured on a year-over-year basis, but impressive productivity growth once again helped to restrain the increase in unit labor costs. The consumer price index rose only ¼ percent at an annual rate over the first three months of the year, as a sharp drop in energy prices offset price increases elsewhere.

Falling long-term interest rates and rising equity prices over the previous year provided substantial impetus to household and business spending in the first quarter. Interest rates dropped sharply further in early January, and although they moved up a little over the remainder of the quarter, nominal yields on long-term Treasury securities were among the lowest in decades. Interest rates continued to benefit from the improvement in the federal budget and the prospect of reduced federal borrowing in the future; rates were also restrained to a significant extent by the effects of the Asian crisis. Equity prices increased sharply in the first quarter, extending their remarkable gains of the previous three years in spite of disappointing news on corporate profits. Households and firms borrowed at a vigorous pace in the first quarter, and growth in the debt of domestic nonfinancial sectors picked up from the fourth quarter of 1997, as did the growth of the monetary aggregates.

At their March meeting, the members of the FOMC confronted unusual cross-currents in the economic outlook. On the price side, the FOMC noted that, although the incoming data were quite favorable, transitory factors were possibly masking underlying tendencies toward higher inflation. Moreover, the available data on household and business spending confirmed the impressive strength of domestic demand and highlighted the possibility that developments in the external sector might not provide sufficient offset in coming quarters to avoid a build-up of inflation pressures. At the same time, the FOMC noted the substantial uncertainty surrounding the prospects for the Asian economies. Balancing these considerations, the FOMC kept its policy stance unchanged but noted that recent information had altered the inflation risks enough to make tightening more likely than easing in the period ahead.

The second quarter brought both a marked further deterioration in the outlook for Asia and some indications that the U.S. economy might be cooling. In Asia, evidence of steep output declines in several countries was combined with mounting concern that economic and financial problems in Japan were not likely to be resolved as quickly as many observers had hoped or expected. One result was a further rise in the exchange value of the dollar and a decline in long-term U.S. interest rates. Increasing investor concern about emerging market economies raised risk spreads on external debts in Asia, Russia, and Latin America.

The higher value of the dollar and the depressed income in many Asian countries continued to take their toll on U.S. exports and to boost imports in the second quarter. In addition, a marked slackening in the pace of inventory accumulation, which was amplified by the effects of a strike in the motor vehicle industry, was reflected in a sharp slowing in domestic demand. Nonetheless, the utilization of labor resources remained very high: In the second quarter, the unemployment rate averaged a bit less than 4½ percent, its lowest quarterly reading in nearly thirty years. The twelve-month change in average hourly earnings indicated that wages were rising somewhat more rapidly than they had a year earlier. And the CPI rose faster in the second quarter than in the first, mainly reflecting a smaller drop in energy prices.

Financial conditions in the second quarter and into July remained supportive of domestic spending. Yields on private securities declined, although less than Treasury yields, as quality spreads widened a bit. Equity prices rose further in early April before falling back over the next two months in response to renewed earnings disappointments. Prices then rebounded substantially, with most major indexes hitting record highs in July. The growth of money and credit slowed a little on balance from the first-quarter pace but remained buoyant. Banks and other lenders continued to compete vigorously, extending credit on generally favorable terms as they responded in part to the sustained healthy financial condition of most businesses and households.

The FOMC left the intended federal funds rate unchanged at its May and June-July meetings. At the May meeting, the FOMC reiterated its earlier concern that the robust expansion of domestic final demand, supported by very positive financial conditions, had raised labor market pressures to a point that might precipitate an upturn in inflation over time. Yet the FOMC believed that the growth of economic activity would slow. It also judged that the risk of significant further deterioration in Asia, which could disrupt global financial markets and impair economic activity in the United States, was rising somewhat.

Economic Projections for 1998 and 1999

The members of the Board of Governors and the Federal Reserve Bank Presidents, all of whom participate in the deliberations of the FOMC, expect economic activity to expand moderately, on average, over the next year and a half. For 1998 as a whole, the central tendency of their forecasts for real GDP growth spans a range of 3 percent to 3¼ percent. For 1999, these forecasts center on a range of 2 percent to 2½ percent. The civilian unemployment rate, which averaged a bit less than 4½ percent in the second quarter of 1998, is expected to stay near this level through the end of this year and to edge higher in 1999. With labor markets remaining tight and some of the special factors that helped restrain inflation in the first half of 1998 unlikely to be repeated, inflation is anticipated to run somewhat higher in the second half of 1998 and in 1999.

The economy is entering the second half of 1998 with considerable strength in household spending and business fixed investment. Consumers are enjoying expanding job opportunities, rising real incomes, and high levels of wealth, all of which are providing them with the confidence and wherewithal to spend. These factors, in conjunction with low mortgage interest rates, are also bolstering housing demand. Business fixed investment appears robust as well: Financial conditions remain conducive to capital spending, and firms no doubt are continuing to seek out opportunities for productivity gains in an environment of rapid technological change, falling prices for high-tech equipment, and tight labor markets.

Nonetheless, a number of factors are expected to exert some restraint on the expansion of activity in the quarters ahead. The demand for U.S. exports will continue to be depressed for a while by weak activity abroad, on average, and by the strong dollar, which will also likely continue to boost imports. The effects of these external sector developments on employment and income growth have yet to materialize fully. In addition, although financial conditions are generally expected to be supportive, real outlays on housing and business equipment have reached such

Economic Projections for 1998 and 1999
Percent

Indicator	Federal Reserve governors and Reserve Bank presidents: Range	Federal Reserve governors and Reserve Bank presidents: Central tendency	Administration
1998			
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	4¼ to 5	4½ to 5	4.2
Real GDP	2¾ to 3¼	3 to 3¼	2.4
Consumer price index[2]	1¼ to 2¼	1¾ to 2	1.6
Average level, fourth quarter			
Civilian unemployment rate	4¼ to 4½	4¼ to 4½	4.8
1999			
Change, fourth quarter to fourth quarter[1]			
Nominal GDP	4 to 5½	4¼ to 5	4.1
Real GDP	2 to 3	2 to 2½	2.0
Consumer price index[2]	1½ to 3	2 to 2½	2.1
Average level, fourth quarter			
Civilian unemployment rate	4¼ to 4¾	4½ to 4¾	5.0

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.
2. All urban consumers.

high levels that gains from here are expected to be more moderate.

With the plunge in energy prices in early 1998 unlikely to be repeated, most FOMC participants expect the CPI for all urban consumers to rise more rapidly in the second half of 1998 than it did in the first half, resulting in an increase in the CPI of 1¾ percent to 2 percent for 1998 as a whole. The pickup in the second half should be limited, however, by further decreases in non-oil import prices, ample domestic manufacturing capacity, and low expected inflation. Looking ahead to next year, the central tendency is for an increase in the CPI of 2 percent to 2½ percent. Absent a further rise in the dollar, the fall in non-oil import prices should have run its course. Moreover, even with the expected edging higher of the unemployment rate next year, the labor market will remain tight, suggesting potential ongoing pressures on available resources that would tend to raise inflation a bit. The FOMC will remain alert to the possibility of underlying imbalances in the economy that could generate a persisting pickup in inflation, which would threaten the economic expansion.

As noted in past monetary policy reports, the Bureau of Labor Statistics is in the process of implementing a series of technical adjustments to make the CPI a more accurate measure of price change. These adjustments and the regular updating of the market basket are estimated to have trimmed CPI inflation somewhat over 1995–98, and a significant further adjustment is scheduled for 1999. All told, the published figures for CPI inflation in 1999 are expected to be more than ½ percentage

Ranges for Growth of Monetary and Debt Aggregates
Percent

Aggregate	1997	1998	Provisional for 1999
M2	1 to 5	1 to 5	1 to 5
M3	2 to 6	2 to 6	2 to 6
Debt	3 to 7	3 to 7	3 to 7

Note. Change from average for fourth quarter of preceding year to average for fourth quarter of year indicated.

point lower than they would have been had the Bureau retained the methods and formulas in place in 1994. In any event, the FOMC will continue to monitor a variety of price measures besides the CPI as it attempts to gauge progress toward the long-run goal of price stability.

Federal Reserve officials project somewhat faster growth in real GDP and slightly higher inflation in 1998 than does the Administration. The Administration's projections for the growth in real GDP and inflation in 1999 are around the lower end of the FOMC participants' central tendencies.

Money and Debt Ranges for 1998 and 1999

At its most recent meeting, the FOMC reaffirmed the ranges for 1998 growth of money and debt that it had established in February: 1 percent to 5 percent for M2, 2 percent to 6 percent for M3, and 3 percent to 7 percent for the debt of the domestic nonfinancial sectors. The FOMC set these same ranges for 1999 on a provisional basis.

Once again, the FOMC chose the growth ranges for the monetary aggregates as benchmarks for growth under conditions of price stability and historical velocity behavior. For several decades before 1990, the velocities of M2 and M3 (defined as the ratios of nominal GDP to the aggregates) behaved in a fairly consistent way over periods of a year or more. M2 velocity showed little trend but varied positively from year to year with changes in a traditional measure of M2 opportunity cost, defined as the interest forgone by holding M2 assets rather than short-term market instruments such as Treasury bills. M3 velocity moved down a bit over time, as depository credit and the associated elements in M3 tended to grow a shade faster than GDP. In the early 1990s, these patterns of M2 and M3 behavior were disrupted, and the velocities of both aggregates climbed well above the levels that were predicted by past relationships. However, since 1994 the velocities of M2 and M3 have again moved roughly in accord with their pre-1990 experience, although their levels remain elevated.

The recent return to historical patterns does not imply that velocity will be fully predictable or even that all movements in velocity can be completely explained in retrospect. Some shifts in velocity arise from household and business decisions to adjust their portfolios for reasons that are not captured by simple measures of opportunity cost. Some shifts in velocity arise from decisions of depository institutions to create more or less credit or to fund credit creation in different ways. All these decisions are shaped by the rapid pace of innovation in financial institutions and instruments. Between 1994 and early 1997, M2 velocity drifted somewhat higher, probably owing to some reallocation of household savings into bond and equity markets. But M2 velocity has declined over the past year despite little change in its traditionally defined opportunity cost. One explanation may be that the flatter yield curve has reduced the return on longer-term investments relative to the bank deposits and money market mutual funds in M2. Another part of the story may be the booming stock market, which has reduced the share of households' financial assets represented by monetary assets and may have encouraged households to rebalance their portfolios by increasing their M2 holdings. M3 velocity has dropped more sharply over the past year, with strong growth in large time deposits and in institutional money funds that are increasingly used by businesses for cash management.

If the velocities of M2 and M3 follow their average historical patterns over the remainder of 1998 and the growth of nominal GDP matches the expectations of Federal Reserve policymakers, these aggregates will finish this year above the upper ends of their respective ranges. Part of this relatively rapid money growth reflects nominal GDP growth in excess of that consistent with price stability and sustainable growth of real output; the rest represents a decline in velocity. Absent unusual changes in velocity in 1999, policymakers' expectations of nominal GDP growth imply that M2 and M3 will be in the upper ends of their price-stability growth ranges next year. The debt of the domestic nonfinancial sectors is expected to remain near the middle of its range this year and in 1999.

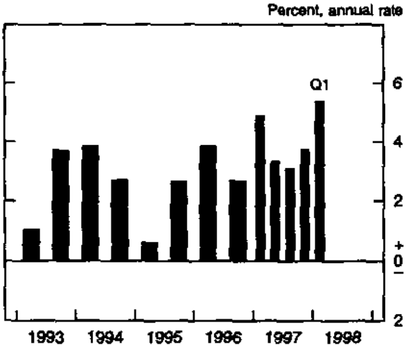
In light of the apparent return of velocity changes to their pre-1990 behavior, some FOMC members have been giving the aggregates greater weight in assessing overall financial conditions and the thrust of monetary policy. However, velocity remains somewhat unpredictable, and all Committee members monitor a wide variety of other financial and economic indicators to inform their policy deliberations. The FOMC decided that the money and debt ranges are best used to emphasize the Committee's commitment to achieving price stability, so it again set the ranges as benchmarks for growth under price stability and historical velocity behavior.

Section 2: Economic and Financial Developments in 1998

The U.S. economy continued to perform well in the first half of the year. The economic difficulties in Asia and the strong dollar reduced the demand for our exports and intensified the pressures on domestic producers from foreign competition. But these effects were outweighed by robust domestic final demand, owing in part to supportive financial conditions, including a higher stock market, ample availability of credit, and long-term interest rates that in nominal terms were among the lowest in many years. Sharp swings in inventory investment were mirrored in considerable unevenness in the growth of real GDP, which appears to have slowed markedly in the second quarter after having soared to nearly 5½ percent at an annual rate in the first quarter. Nonetheless, over the first half as a whole, the rise in real output was large enough to support sizable gains in employment and to push the unemployment rate down to the range of 4¼ to 4½ percent, the lowest in decades.

The further tightening of labor markets in recent quarters has been reflected in a more discernible uptilt to the trend in hourly compensation. But price inflation remained subdued in the first half of the year, held down in part by a sharp decline in energy prices and lower prices for non-oil imports. Intense competition in product markets, ample plant capacity, ongoing productivity gains, and damped inflation expectations also helped to restrain inflation pressures in the face of tight labor markets.

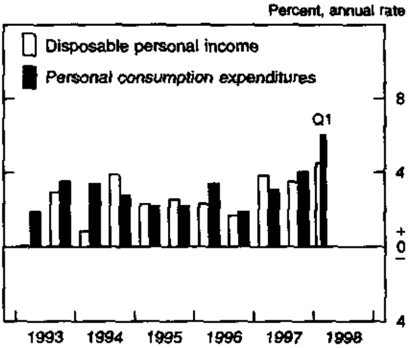
Change in Real GDP



The Household Sector

Consumer Spending. The factors that fueled the sizable increase in household expenditures in 1997 continued to spur spending in the first half of 1998: Growth in employment and real disposable income remained very strong, and households in the aggregate enjoyed significant further gains in net worth. Reflecting these developments, sentiment indexes suggest that consumers continued to feel extraordinarily upbeat about the current and prospective condition of the economy and their own financial situations.

Change in Real Income and Consumption



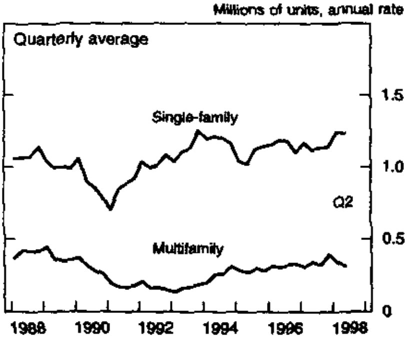
In total, real consumer outlays rose at an annual rate of 6 percent in the first quarter, and the available data point to another large increase in the second quarter. Increases in spending were broad-based, but outlays for durable goods were especially strong. Declining prices and ongoing product innovation continued to stimulate demand for personal computers and other home electronic equipment. In addition, purchases of motor vehicles were sustained by a combination of solid fundamentals and attractive pricing. Indeed, since 1994, sales of light vehicles have been running at a brisk pace of 15 million units (annual rate), and, in the second quarter, a round of very attractive manufacturers' incentives helped lift sales to a pace of 16 million units.

Spending on services also remained robust in the first half of the year, with short-run variations reflecting in part the effects of weather on household energy use; outlays on personal business services, including those related to financial transactions, and on recreation services continued to exhibit remarkable strength. In addition, real outlays for nondurable goods, which rose only moderately last year, grew about 6½ percent at an annual rate in the first quarter, and they appear to have posted another sizable increase in the second quarter.

Real disposable income—that is, after-tax income adjusted for inflation—remained on a strong uptrend in early 1998: It rose about 4 percent at an annual rate between the fourth quarter of 1997 and May 1998. This increase in part reflected a sharp rise in aggregate wages and salaries, which were boosted by sizable gains in both employment and real wage rates; dividends and nonfarm proprietors' incomes also rose appreciably. However, growth in after-tax income (as measured in the national income and product accounts) was restrained by large increases in personal income tax payments—likely owing in part to taxes paid on realized capital gains; capital gains—whether realized or not—are not included in measured income. Reflecting the movements in spending and measured income, the personal saving rate fell from an already low level of about 4 percent in 1997 to 3½ percent during the first five months of 1998.

Residential Investment. Housing activity continued to strengthen in the first half of 1998, especially in the single-family sector, where starts rose noticeably and sales of both new and existing homes soared. Indeed, the average level of single-family starts over the first five months of the year—1¼ million units at an annual rate—was 9 percent above the pace for 1997 as a whole. Moreover, surveys by the National Association of Homebuilders suggested that housing demand remained vigorous at midyear, and the Mortgage Bankers Association reported that loan applications for home purchases have been around all-time highs of late.

Private Housing Starts



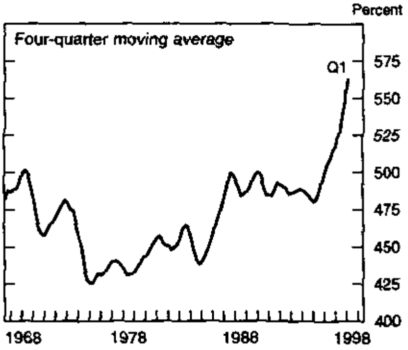
Note. Values for 1998:Q2 are the average of April and May.

The strong demand for homes has contributed to some firming of house prices, which are now rising in the neighborhood of 3 to 5 percent per year, according to measures that control for shifts in the regional composition of sales and attempt to minimize the effects of changes in the mix of the structural features of houses sold. In nominal terms, these increases are well within the range of recent years; however, in real terms, they are among the largest since the mid-1980s—a development that should reinforce the investment motive for homeownership. Of course, rising house prices may make purchasing homes more difficult for some families. But, with income growth strong and mortgage rates around 7 percent (thirty-year conventional fixed-rate loans), homeownership is as affordable as it has been at any time in the past thirty years. Moreover, innovative programs that relax the standards for mortgage qualification are helping low-income families to finance home purchases. Also, stock market gains have probably boosted demand among higher-income groups, especially in the trade-up and second-home segments of the market.

After having surged in the fourth quarter of 1997, multifamily starts settled back to about 325,000 units (annual rate) over the first five months of 1998, a pace only slightly below that recorded over 1997 as a whole. Support for multifamily construction continued to come from the overall strength of the economy, which undoubtedly has stimulated more individuals to form households, as well as from low interest rates and an ample supply of financing. In addition, real rents picked up over the past year, and the apartment vacancy rate appears to be edging down.

Household Finance. Household net worth rose sharply in the first quarter, pushing the wealth-to-income ratio to another record high. Although the flow of new personal saving was quite small, the revaluation of existing assets added considerably to wealth, with much of these capital gains accumulated on equities held either directly or indirectly through mutual funds and retirement accounts. Of course, these gains have been distributed quite

Household Net Worth Relative to
Disposable Personal Income



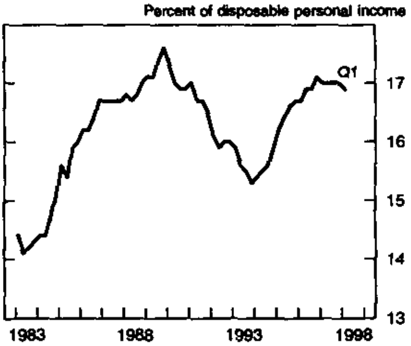
unevenly: The 1995 Survey of Consumer Finances reported that 41 percent of U.S. families own equities in some form, but that families with higher wealth own a much larger share of total equities.

In the first quarter of this year, the runup in wealth, together with low interest rates and high levels of confidence about future economic conditions, supported robust household spending and borrowing. The expansion of household debt, at an annual rate of 7¾ percent, was above last year's pace and once again outstripped growth in disposable income. The consumer credit component of household debt grew 4½ percent at an annual rate in the first quarter, a pace roughly double that for the fourth quarter of last year but near the 1997 average. Preliminary data for April and May point to a somewhat smaller advance in the second quarter.

Mortgage debt increased 8¼ percent at an annual rate in the first quarter, the same as its fourth-quarter advance and a little above its 1997 growth rate. Fixed-rate mortgage interest rates were 15 basis points lower in the first quarter than three months earlier and 75 basis points lower than a year earlier, which encouraged both new home purchases and a surge of refinancing of existing mortgages. Within total gross mortgage borrowing, the flattening of the yield curve made adjustable-rate mortgages less attractive relative to fixed-rate mortgages, and their share of originations reached the lowest point in recent years. Net borrowing can be boosted by refinancings if households "cash out" some housing equity, but the magnitude of this effect is unclear. In any event, continued expansion of bank real estate lending and a high level of mortgage applications for home purchases suggest a further solid gain in mortgage debt in the second quarter. Home equity credit at banks increased only 2 percent at an annual rate from the fourth quarter of 1997 through June 1998 after having posted a 15½ percent gain last year; this slowdown may reflect a diminished substitution of mortgage debt for consumer debt or simply the increase in mortgage refinancings, which allowed households to pay down more expensive home equity debt or to convert housing equity into cash in a more advantageous manner.

Despite the further buildup of household indebtedness, financial stress among households appears to have stabilized after several years of deterioration. In the aggregate, estimated required payments of loan principal and interest have held about steady relative to disposable personal income—albeit at a high level—since 1996. Over this period, the effect on debt burdens of faster growth of debt than income has been roughly offset by declining interest rates and the associated refinancing of higher interest-rate debt, as well as by a shift toward mortgage debt (which has a longer repayment period). Various measures of delinquency rates on consumer loans leveled off or declined in 1997, and delinquency rates on mortgages have been at very low levels for several years. Personal bankruptcy filings reached a new record high in the first quarter of 1998, but this represented only 6 percent more filings than four quarters earlier, which is the smallest such change in three years.

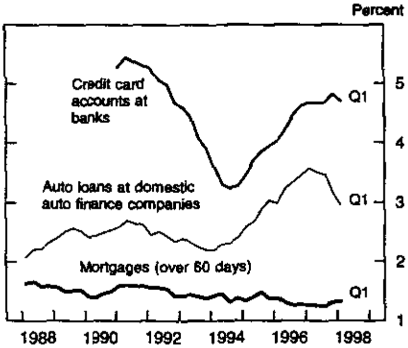
Household Debt-Service Burden



NOTE. Debt service is the sum of estimated required interest and principal payments on consumer and household-sector mortgage debt.

These developments have apparently suggested to banks that they have sufficiently tightened terms

Delinquency Rates on Household Loans



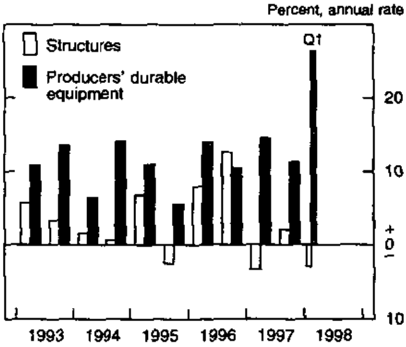
Note. Data on credit-card delinquencies are from the Call Report; data on mortgage delinquencies are from the Mortgage Bankers Association.

and standards on consumer loans. In the Federal Reserve's May Senior Loan Officer Opinion Survey on Bank Lending Practices, relatively few banks, on net, reported tightening standards on credit card or other consumer loans. Little change was reported in the terms of consumer loans.

The Business Sector

Fixed Investment. Real business fixed investment appears to have posted another hefty gain over the first half of 1998 as spending continued to be boosted by positive sales expectations in many industries; favorable financial conditions; and a perceived opportunity, if not a necessity, for firms to install new technology in order to remain competitive. The

Change in Real Business Fixed Investment



exceptional growth of investment since the early 1990s has been facilitated in part by the increase in national saving associated with the elimination of the federal budget deficit. It has resulted in considerable modernization and expansion of the nation's capital stock, which have been important in the improved performance of labor productivity over the past few years and which should continue to lift productivity in the future. Moreover, rapid investment in the manufacturing sector in recent years has resulted in large additions to productive capacity, which have helped keep factory operating rates from rising much above average historical levels in the face of appreciable increases in output.

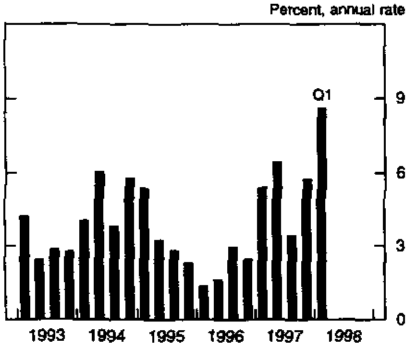
Real outlays for producers' durable equipment, which have been rising more than 10 percent per year, on average, since the early 1990s, moved sharply higher in the first half of 1998. All major categories of equipment spending recorded sizable gains in the first quarter; but as has been true throughout the expansion, outlays for computers rose especially rapidly. Real computer outlays received particular impetus in early 1998 from extensive price-cutting. Purchases of communications equipment have also soared in recent quarters; the rise reflects intense pressures to add capacity to accommodate the growth of networking; the rapid pace of technological advance, especially in wireless communications; and regulatory changes. As for the second quarter, data on shipments, coupled with another steep decline in computer prices, point to a further substantial increase in real computer outlays. Spending on motor vehicles apparently continued to advance as well while demand for other types of capital equipment appears to have remained brisk.

In total, real outlays on nonresidential construction flattened out in 1997 after four years of gains, and they remained sluggish in early 1998. Construction of office buildings remained robust in the first half of this year, after having risen at double-digit rates in 1996 and 1997, and outlays for institutional buildings continued to trend up. However, expenditures for other types of structures were lackluster. Nonetheless, the economic fundamentals for the sector as a whole remain quite favorable: Vacancy rates for office and retail space have continued to fall; real estate prices, though still well below the levels of the mid-1980s in real terms, have risen appreciably in recent quarters; and funding for new projects remains abundant.

Inventory Investment. The pace of stockbuilding by nonfarm businesses picked up markedly in

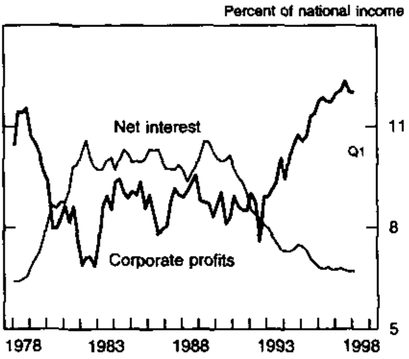
1997 and is estimated to have approached $100 billion (annual rate) in the first quarter of 1998—equal to an annual rate increase of 8½ percent in the level of inventories and accounting for more than 1½ percentage points of that quarter's growth in real GDP. The first-quarter accumulation was heavy almost across the board. Among other things, it included a large increase in stocks of petroleum as the unusually warm weather reduced demand for refined products and low prices provided an incentive for refiners and distributors to accumulate stocks. However, overall sales were also very strong, and with only a few exceptions—notably, semiconductors, chemicals, and textiles—stocks did not seem out of line with sales. In any event, fragmentary data for the second quarter point to a considerable slowing in inventory investment that is especially evident in the motor vehicle sector, where stocks were depleted by the combination of strong sales and GM production shortfalls. In addition, petroleum stocks appear to have grown less rapidly than they did in the first quarter, and stockbuilding elsewhere slowed sharply in April and May.

Change in Real Nonfarm Business Inventories



Corporate Profits and Business Finance. Businesses have financed a good part of their investment this year through continued strong cash flow, but they have also increased their reliance on financial markets. Economic profits (book profits after inventory valuation and capital consumption adjustments) have run at 12 percent of national income over the past year, well above the 1980s peak of roughly 9 percent. However, the strength in profits has resulted partly from the low level of net interest payments, leaving total capital income at roughly the same share of national income as at the 1980s peak.

Corporate Profits and Net Interest



Note. Corporate profits include inventory valuation and capital consumption adjustments.

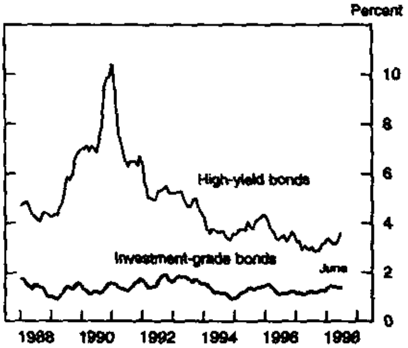
Overall, a major portion of the increase in profits between the 1980s and the 1990s represents a realignment of returns from debt-holders to equity-holders.

Although their level remains high, the growth of profits has slowed: Economic profits rose 4¾ percent at an annual rate in the first quarter compared with 9½ percent between the fourth quarter of 1996 and the fourth quarter of 1997. This slowdown may have resulted from various causes, including rising employee compensation and the Asian financial crisis. Quantifying the effect of the Asian turmoil is difficult: Although only a small share of the profits of U.S. companies is earned in the directly affected Asian countries, the crisis has reduced the prices of U.S. imports and thereby put downward pressure on domestic prices.

Nonfinancial businesses realized annualized economic profit growth of only 1¼ percent in the first quarter. Because capital expenditures (including inventory investment) grew much faster, the financing gap—the excess of capital expenditures over retained earnings—widened. As a result, these businesses used less of their cash flow to retire outstanding equity and continued to borrow at the rapid pace of the fourth quarter of 1997, with debt expanding at an annual rate of 9 percent in the first quarter of 1998. Outstanding amounts of both bonds and commercial paper rose especially sharply. The decline in long-term interest rates around year-end encouraged companies to lock in those yields, and gross bond issuance reached a record high in the first quarter of 1998. Borrowing by nonfinancial businesses increased at a slightly slower but still rapid clip in the second quarter, with little change in outstanding commercial paper but very strong net bond issuance and some rebound in bank loans.

Despite persistent high borrowing, external funding for businesses remained readily available on favorable terms. The spreads between yields on investment-grade bonds and yields on Treasury bonds widened a little from low levels, with investors favoring Treasury securities over corporate securities as a haven from Asian turmoil and, perhaps, with disappointing profits leading to some minor reassessment of the underlying risk of private obligations. The spreads on high-yield bonds also increased, in part because of heavy issuance of these bonds this spring, but they remain narrow by historical standards. In the Federal Reserve's May survey on bank lending practices, banks reported negligible change in business loan standards; moreover, yield spreads on bank loans remained low for both large and small firms. Surveys by the National Federation of Independent Business suggest that small firms have been facing little difficulty in obtaining credit.

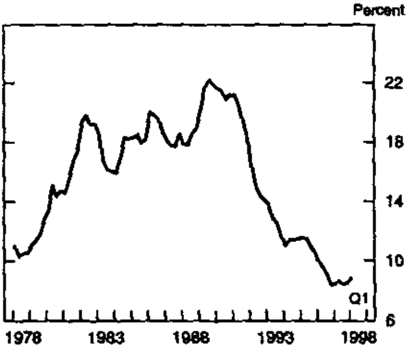
Spreads Between Yields on Private and Treasury Securities



Note. The spread on high-yield bonds compares the yield on the Merrill Lynch Master II index with that on a seven-year Treasury note; the spread on investment-grade bonds compares the yield on Moody's index of A-rated bonds with that on a ten-year Treasury note.

The ready availability of credit has stemmed importantly from the healthy financial condition of many businesses, which have enjoyed an extended period of economic expansion and robust profits. The aggregate debt-service burden for nonfinancial corporations, measured as the ratio of net interest

Net Interest Payments of Nonfinancial Corporations Relative to Cash Flow



payments to cash flow, dropped substantially between 1990 and 1996 and remains modest, despite edging up in the first quarter of this year. In addition, most measures of financial distress have shown favorable readings. The delinquency rate on commercial and industrial bank loans has stayed very low since 1995, preserving the dramatic decline that occurred in the first half of the decade. After moving up a little in 1996 and 1997, business failures decreased in the first five months of 1998; the liabilities of failed businesses as a share of total liabilities was less than one-quarter the value reached in the early 1990s. At the same time, Moody's upgraded significantly more debt than it downgraded, and the rate of junk bond defaults stayed close to its low 1997 level.

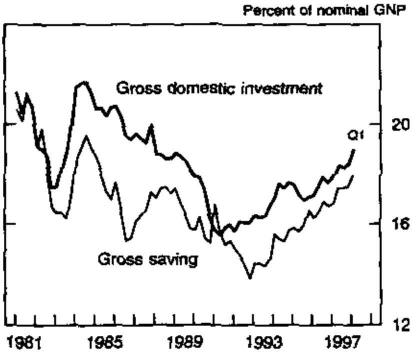
Net equity issuance was less negative in the first quarter of this year than in the fourth quarter of last year, but nonfinancial corporations still retired, on net, about $100 billion of equity at an annual rate. The wave of merger announcements this spring will likely generate strong share retirements over the remainder of the year. Gross equity issuance in the first half of 1998 was close to its pace of the past several years, although investors seemed somewhat cautious about initial public offerings.

The Government Sector

Federal Government. The incoming news on the federal budget continues to be very positive. Over the twelve months ending in May 1998, the unified budget registered a surplus of $60 billion, compared with a deficit of $65 billion during the twelve months ending in May 1997. Soaring receipts continued to be the main force driving the improvement in the budget, but subdued growth in outlays also played a key role. If the latest projections from OMB and CBO are realized, the unified budget for fiscal year 1998 as a whole will show a surplus of roughly $40 billion to $65 billion.

With the federal budget having shifted into surplus, the federal government is now augmenting, rather than drawing on, the pool of national saving. In fact, the improvement in the government's budget position over the past several years has been large enough to generate a considerable rise in gross domestic saving despite a decline in the private saving rate; all told, gross saving by households, businesses, and governments increased from about 14½ percent of gross national product in the early 1990s, when federal saving was at a cyclical low, to more than 17 percent of GNP in recent quarters. This increase in domestic saving, along with increased borrowing from abroad, has financed the surge in domestic investment in this expansion. Moreover, this year's budgetary surplus will continue to pay benefits in future years because it allows the government to reduce its outstanding debt, which implies smaller future interest payments and, all else equal, makes it easier to keep the budget in surplus. If, in fact, the budget outcome over the next several years is as favorable as OMB and CBO now anticipate under current policies, the reduction in the outstanding debt could be substantial.

Saving and Investment



Note. Gross saving consists of saving of households, businesses, and governments. Gross domestic investment is the sum of gross private domestic investment and government investment. The gap between gross saving and gross domestic investment is equal to the sum of net foreign investment and the statistical discrepancy from the national income and product accounts.

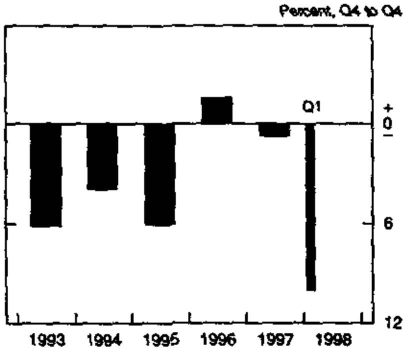
Federal receipts in the twelve months ending in May 1998 were 10 percent higher than in the same period a year earlier—roughly twice the percentage increase for nominal GDP over the past year. Individual income tax receipts, which have been rising at double-digit rates since the mid-1990s, continued to do so over the past year as the surge in capital gains realizations likely persisted and sizable gains in real income raised the average tax rates on many households (the individual income tax structure being indexed for inflation but not for growth in real incomes). In contrast to the ongoing strength in individual taxes, corporate tax payments increased only moderately over the past year, echoing the deceleration in corporate profits.

Federal expenditures in the twelve months ending in May 1998 were only 1½ percent higher in nominal terms than during the twelve months ending in May 1997, with restraint evident in most categories. Outlays for defense were about unchanged, as were those for income security programs. In the latter category, outlays for low-income support fell as economic activity remained robust, welfare reform capped outlays for family assistance, and enrollment rates in other programs dropped. In the health area, spending on Medicaid picked up somewhat after a period of extraordinarily small increases, whereas growth in spending for Medicare slowed, in part because of the programmatic changes that were legislated in 1997. And, with interest rates little changed and the stock of outstanding federal debt no longer rising, net interest payments stabilized.

Real federal outlays for consumption and gross investment, the part of federal spending that is counted in GDP, fell about 2 percent between the first quarters of 1997 and 1998. The decrease was concentrated in real defense spending, which fell about 2¾ percent, roughly the same as over the preceding four quarters; real nondefense spending was unchanged, on balance. In the first quarter, real federal outlays fell at a 10 percent annual rate; the drop reflected a plunge in defense spending, which appears to have been reversed in the second quarter.

With debt held by the public close to $4 trillion, the government will continue to undertake substantial gross borrowing in order to redeem maturing securities. The government will also continue to adjust its issuance of short-term debt to accommodate seasonal swings in receipts and spending. The surplus during the first half of calendar year 1998—boosted by the huge inflow of individual income tax receipts—enabled the Treasury to reduce its outstanding debt

Change in Real Federal Expenditures
on Consumption and Investment



Note. Value for 1998:Q1 is a quarterly percent change at an annual rate.

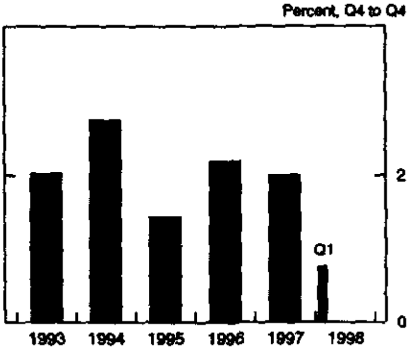
$57 billion while augmenting its cash balance $40 billion. The reduction in debt included net paydowns of coupon securities and bills.

Looking ahead to projected surpluses for coming years, the Treasury announced that it will no longer issue three-year notes and will auction five-year notes quarterly rather than monthly. Over the past several years, the Treasury has accommodated the surprising improvement in federal finances by substantially reducing both bill and coupon issuance. The Treasury hopes that concentrating future coupon offerings in larger, less-frequent auctions will maintain the liquidity of these securities while still allowing for sufficient issuance of bills to maintain their liquidity as well. These changes are also intended to prevent further upcreep in the average maturity of the outstanding debt held by private investors, now standing at sixty-five months. The Treasury continues to work on encouraging the market for inflation-indexed securities, issuing a thirty-year indexed bond in April to complement the existing five-year and ten-year indexed notes.

State and Local Governments. The fiscal position of state and local governments in the aggregate has also remained quite favorable. Strong growth of household income and consumer spending has continued to lift revenues, despite numerous small tax cuts, and governments have continued to hold the line on expenditures. As a result, the consolidated current account of the sector, as measured by the surplus (net of social insurance funds) of receipts over current expenditures in the national income and product accounts, held steady in the first quarter at around $35 billion (annual rate), roughly where it has been since 1995. State governments, which have reaped the main benefits of rising income taxes, have fared especially well: Indeed, all of the forty-seven states whose fiscal years ended by June 30 appear to have achieved balance or to have run surpluses in their general funds budgets in fiscal year 1998.

Real expenditures for consumption and gross investment by states and localities have been rising about 2 percent per year, on average, since the early 1990s, and the increase in spending for the first half of 1998 appears to have been a bit below that trend. These governments added jobs over the first half of the year at about the same rate as they did over 1997 as a whole. However, real construction outlays, which have been drifting down since early 1997, posted a sizable decline in the first quarter, and monthly data suggest that spending dropped further in the spring. The weakness in construction spending over the past year has cut across the major categories of construction and is puzzling in light of the sector's ongoing infrastructure needs and the good financial shape of most governments.

Change in Real State and Local Expenditures
on Consumption and Investment



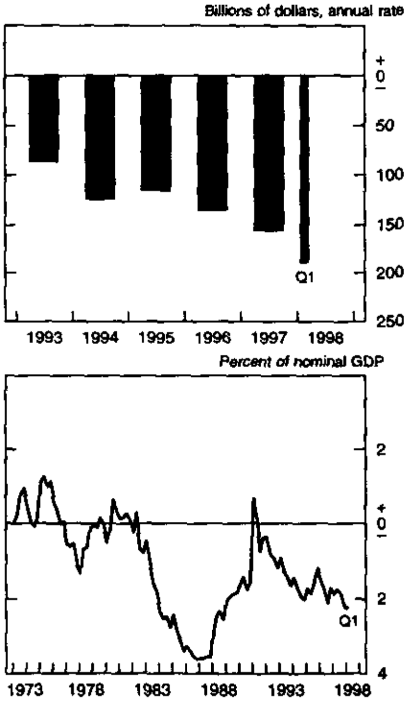
Note. Value for 1998:Q1 is a quarterly percent change at an annual rate.

State and local governments responded to the low interest rates during the first half of the year by borrowing at a rapid rate, both to refinance outstanding debt and to fund new capital projects. Because debt retirements eased in the first quarter relative to the fourth quarter of 1997, net issuance increased substantially. Meanwhile, credit quality of state and local debt continued to improve, with much more debt upgraded than downgraded in the first half of the year.

External Sector

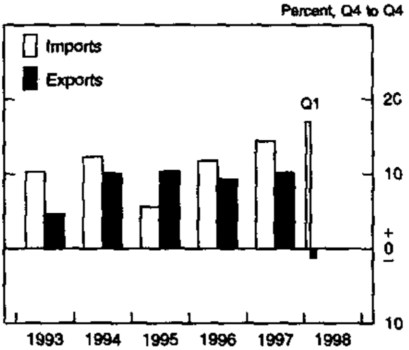
Trade and the Current Account. The nominal trade deficit on goods and services widened to $140 billion at an annual rate in the first quarter from $114 billion in the fourth quarter of last year. The current account deficit for the first quarter reached $189 billion (annual rate), 2¼ percent of GDP, compared with $155 billion for the year 1997. A larger deficit on net investment income as well as the widening of the deficit on trade in goods and services contributed to the deterioration in the first quarter of the current account balance. In April and May, the trade deficit increased further.

U.S. Current Account



The quantity of imports of goods and services again grew vigorously in the first quarter. The annual rate of expansion at 17 percent exceeded that for 1997 and reflected the continued strength of U.S. economic activity and the effects of past dollar appreciation. Imports of consumer goods, automotive products, and machinery were particularly robust. Preliminary data for April and May suggest that real import growth remained strong. Non-oil import prices fell sharply through the second quarter, reflecting the rise in the exchange value of the dollar over the past year.

Change in Real Imports and Exports of Goods and Services



Note. Value for 1998:Q1 is a quarterly percent change at an annual rate.

The quantity of exports of goods and services declined at an annual rate of 1 percent in the first quarter, the first such absolute drop since the first quarter of 1994. The weakness of economic activity in a number of our trading partners, with absolute declines in several economies in Asia, and the strength of the dollar, which also partly resulted from the Asian financial crises, largely account for the abrupt halt in the growth of real exports after a 10 percent rise last year. Declines were recorded for machinery, industrial supplies, and agricultural products. Exports to the emerging market economies in Asia, particularly Korea, as well as exports to Japan were down sharply while exports to western Europe and Canada rose moderately. Preliminary data for April and May suggest that real exports declined further.

The Capital Account. Foreign direct investment in the United States and U.S. direct investment abroad continued at near record levels in the first quarter of 1998, spurred by strong merger and acquisition activity across national borders.

In the first quarter, the booming U.S. stock market continued to attract large foreign interest. Net purchases by private foreigners were $29 billion, following record net purchases of $66 billion in the year 1997. Foreign net purchases of U.S. corporate bonds remained substantial, and net purchases of U.S. government agency bonds reached a record $21 billion. In contrast, net sales of U.S. Treasury securities by private foreigners, particularly large net sales booked at a Caribbean financial center, were recorded in the first quarter. U.S. net purchases of foreign stocks and bonds were modest.

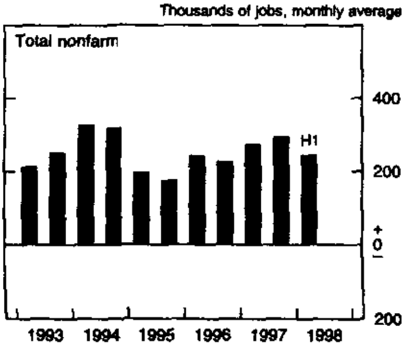
Foreign official assets in the United States increased $10 billion in the first quarter. However, the net increase in the second quarter was limited by large dollar sales by Japan.

The Labor Market

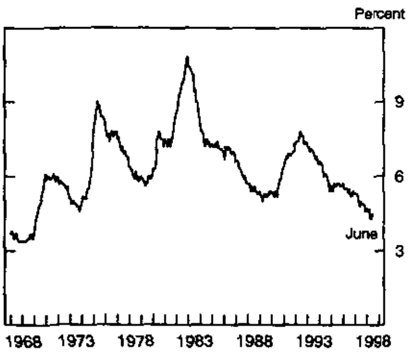
Employment and Labor Supply. Labor demand remained robust during the first half of 1998. Growth in payroll employment averaged 243,000 per month, only a little less than in 1997 and well above the rate consistent with the growth in the working-age population. The unemployment rate held steady in the first quarter at 4¾ percent but dropped to the range of 4¼ percent to 4½ percent in the second quarter.

The services industry, which accounts for about 30 percent of nonfarm employment, continued to be the mainstay of employment growth over the first half

Change in Payroll Employment



Unemployment Rate

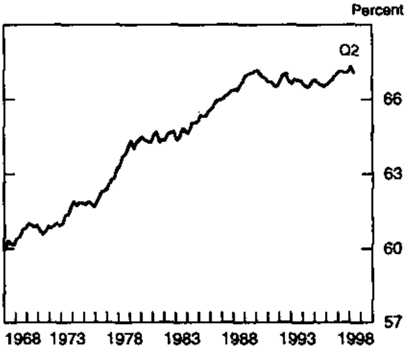


of 1998, posting increases of 115,000 per month, on average. Within services, hiring remained brisk at computer and data-processing firms and at firms providing engineering and managerial services, but payrolls at temporary help agencies rose much less rapidly than they had over the preceding few years—apparently in part reflecting difficulties in finding workers, especially for highly skilled and technical positions. Sizable increases were also posted at wholesale and retail trade establishments and in the finance, insurance, and real estate category. Construction payrolls were bounced around by unusual winter weather but, on average, rose a brisk 21,000 per month—about the same as in 1997.

In contrast to the robust gains elsewhere, manufacturing firms curbed their hiring in the first half of 1998 in the face of slower growth in factory output. After having risen a torrid 6¼ percent in 1997, factory output increased at an annual rate of about 2½ percent between the fourth quarter of last year and May 1998; the deceleration reflected the effects of the Asian crisis as well as a downshift in motor vehicle assemblies and the completion of the 1996–97 ramp-up in aircraft production. In June, factory output is estimated to have fallen ½ percent; the GM strike accounted for the decline.

The labor force participation rate—which measures the percentage of the working-age population that is either employed or looking for work—trended up mildly over the past couple of years and stood at 67.1 percent, on average, in the first half of 1998, slightly above the previous cyclical highs achieved in late 1989 and early 1990. Participation among adult women has picked up noticeably in recent years, after having risen only slowly in the first half of the 1990s, and participation among adult men, which had been on a gradual downtrend through mid-decade, appears to have leveled out. In contrast, participation rates for teenagers, for whom school enrollment rates have risen, have continued to sag after having dropped sharply in the early 1990s. Strong labor demand clearly contributed importantly to the rise in overall participation over the past several years, but the expansion of the earned income tax credit and changes in the welfare system probably provided added stimulus.

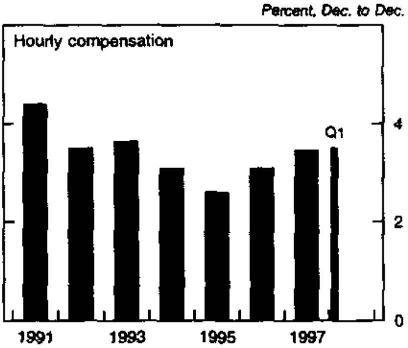
Labor Force Participation Rate



Note. Data before 1994 have been adjusted by the FRB staff for the redesign of the household survey.

Labor Costs and Productivity. Firms no doubt are continuing to rely heavily on targeted pay increases and incentives like stock options and bonuses to attract and retain workers. But the tightness of the labor market also appears to be exerting some upward pressure on traditional measures of hourly compensation, which have exhibited a somewhat more pronounced uptrend of late. Indeed, the twelve-month change in the employment cost index (ECI) for private industry workers picked up to 3½ percent in March, compared with 3 percent for the twelve months ending in March 1997 and 2¾ percent for the twelve months ending in March 1996. Hourly compensation accelerated especially rapidly for employees of finance, insurance, and real estate firms, some of whom received sizable bonuses and commissions. However, the acceleration was fairly widespread across industries and occupations and, given the relatively small rise in consumer prices

Change in Employment Cost Index



Note. Data are for private industry, excluding farm and household workers. The value for 1998:Q1 is measured from March 1997 to March 1998.

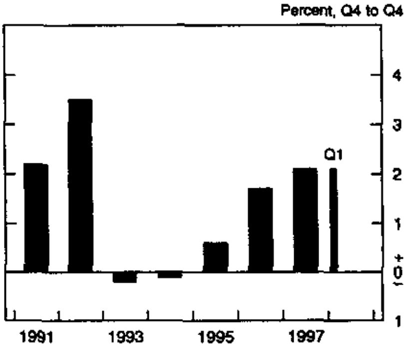
over the past year, implies a solid increase in real pay for many workers.

The acceleration in hourly compensation costs over the past year resulted mainly from faster growth of wages and salaries, which rose 4 percent over the twelve months ending in March; this increase was about ½ percentage point larger than the one recorded over the preceding twelve months. Separate data on average hourly earnings of production or nonsupervisory workers also show an ongoing acceleration of wages: The twelve-month change in this series was 4.1 percent in June, ½ percentage point above the reading for the preceding twelve months.

Benefits costs have generally remained subdued, with the increase over the year ending in March amounting to only about 2¼ percent. According to the ECI, employer payments for health insurance have picked up moderately in recent quarters after having been essentially flat over the previous couple of years, and indications are that further increases may be in the offing. Insurers whose profit margins had been squeezed in recent years by pricing strategies designed to gain market share reportedly are raising premiums, and many managed care plans are adding innovations that, while offering greater flexibility and protections to consumers, may boost costs. Additional upward pressure on premiums apparently has come from higher spending on prescription drugs. Among other major components of benefits, rising equity prices have reduced the need for firms to pay into defined benefit plans, and costs for state unemployment insurance and workers' compensation have fallen sharply.

Labor productivity in the nonfarm business sector posted another sizable advance in the first quarter of 1998, bringing the increase over the year ending in the first quarter to an impressive 2 percent.[1] Taking a slightly longer perspective, productivity has risen a bit more than 1½ percent per year, on average, over the past three years, after having risen less than 1 percent per year, on average, over the first half of the decade. At least in part, the recent strong productivity growth has likely been a cyclical response to the marked acceleration of output. But it is also possible that the high levels of business investment over the past several years—and the associated rise in the amount of capital per worker—are translating into a stronger underlying productivity trend. In addition, productivity apparently is being buoyed by the assimilation of new technologies into the workplace. In any event, the faster productivity growth of late is helping to offset the effects of higher hourly compensation on unit labor costs and prices, thereby allowing wages to rise in real terms.

Change in Output per Hour



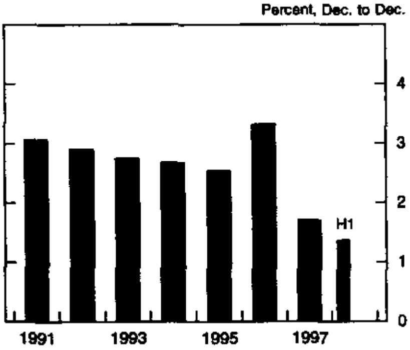
Note. Nonfarm business sector. Value for 1998:Q1 is the percent change from 1997:Q1 to 1998:Q1.

1. According to the published data, productivity rose 1.1 percent at an annual rate in the first quarter. However, these data are distorted by inconsistencies in the measurement of hours associated with varying lengths of pay periods across months. Although the Bureau of Labor Statistics has already revised the monthly hours and earnings data to account for these inconsistencies, it will not update the productivity statistics until August. All else being equal, adjusting the productivity data to reflect the Bureau's revisions to hours would substantially raise productivity growth in the first quarter, but it would have little effect on the change over the four quarters ending in the first quarter.

Prices

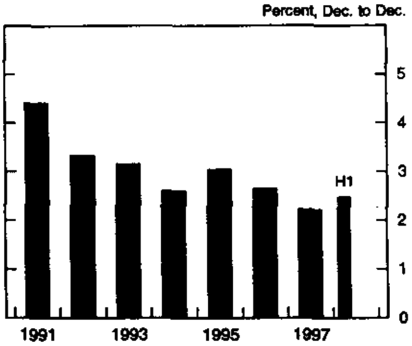
Price inflation remained quiescent in the first half of this year. After having increased 1¾ percent in 1997, the consumer price index (CPI) slowed to a crawl in early 1998 as energy prices plummeted, and it recorded a rise of only about 1½ percent at an annual rate over the first six months of the year. The increase in the CPI excluding food and energy—the so-called "core CPI"—picked up to 2½ percent (annual rate) over the first half of the year. However, this pickup follows some unusually small increases in the

Change in Consumer Prices



Note. Consumer price index for all urban consumers. Value for 1998:H1 is the percent change from December 1997 to June 1998 at an annual rate.

Change in Consumer Prices Excluding Food and Energy



Note. Consumer price index for all urban consumers. Value for 1998:H1 is the percent change from December 1997 to June 1998 at an annual rate.

Alternative Measures of Price Change
Percent

Price measure	1996:Q1 to 1997:Q1	1997:Q1 to 1998:Q1
Fixed weight		
Consumer price index	2.9	1.5
Excluding food and energy	2.5	2.3
Chain type		
Personal consumption expenditures	2.6	1.0
Excluding food and energy	2.3	1.4
Gross domestic product	2.2	1.4

Note. Changes are based on quarterly averages.

second half of 1997, and the twelve-month change has held fairly steady at about 2¼ percent since late last summer. The chain price index for personal consumption expenditures on items other than food and energy rose only 1½ percent over the year ending in the first quarter of 1998—the most recent information available; this measure typically rises less rapidly than does the core CPI, in part because it is less affected by so-called "substitution bias."

The relatively favorable price performance in the first half of 1998 reflected a number of factors that, taken together, continued to exert enough restraint to offset the upward pressures from strong aggregate demand and high levels of labor utilization. One was the drop in oil prices. In addition, non-oil import prices continued to fall, thus further lowering input costs for many domestic industries and limiting the ability of firms facing foreign competition to raise prices for fear of losing sales to producers abroad. Prices of manufactured goods were also held in check by the sizable increase in domestic industrial capacity in recent years and by developments in Asia, which, among other things, led to a considerable softening of commodity prices. Moreover, the various surveys of consumers and forecasters suggest that inflation expectations stayed low—even declined in some measures. For example, according to the Michigan survey, median one-year inflation expectations dropped a bit further this year, after having held fairly steady over 1996 and 1997, and inflation expectations for the next five to ten years edged down from about 3 percent, on average, in 1996 and 1997 to 2¾ percent in the second quarter of 1998.

The CPI for goods other than food and energy rose at an annual rate of 1 percent over the first six months of 1998, only a bit above the meager ½ percent rise over 1997 as a whole. In the main, the step-up reflected a turnaround in prices of used cars and trucks, and prices of tobacco products and prescription drugs also rose considerably faster than they had in 1997. More generally, prices continued to be restrained by the effect of the strong dollar on prices of import-sensitive goods. For example, prices of new vehicles fell slightly over the first half of the year while prices of other import-sensitive goods—such as apparel and audio-video equipment—were flat or down. In the producer price index, prices of capital equipment were little changed, on balance, over the first half of 1998; they, too, were damped by the competitive effects of falling import prices.

The CPI for non-energy services increased 3 percent over the first six months of 1998, about the same as last year's pace. After having fallen somewhat last year, airfares picked up in the first half of the year, and owner's equivalent rent seems to be rising a bit faster than it did in 1997. In addition, increases in prices of medical services, which had slowed to about 3 percent per year in 1996–97, have been running somewhat higher so far this year. Price changes for most other major categories of services were similar to or smaller than those recorded in 1997.

Energy prices fell sharply in early 1998 as the price of crude oil came under severe downward pressure from weak demand in Asia, a decision by key OPEC producers to increase output, and a relatively warm winter in the Northern Hemisphere. After averaging about $20 per barrel in the fourth quarter of 1997, the spot price of West Texas intermediate dropped to a monthly average of $15 per barrel in March, where it more or less remained through the spring. Crude prices dropped sharply in June following reports of high levels of inventories and revised estimates of oil consumption in Asia but have since firmed in response to an agreement by major oil producers to restrict supply in the months ahead; they now stand at $14½ per barrel. Reflecting the decline in crude prices, retail energy prices fell at an annual rate of 12 percent over the first half of the year, led by a steep drop in gasoline prices.

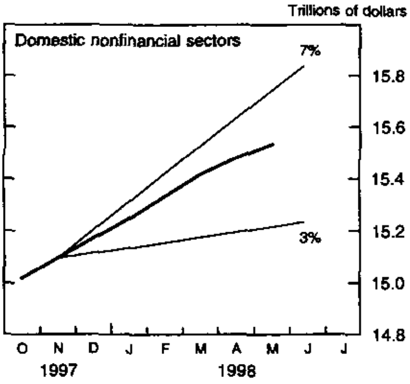
Developments in the agricultural sector also helped to restrain overall inflation in the first half of this year. Excluding the prices of fruits and vegetables—which tend to be bounced around by short-term swings in the weather—food prices have been rising a scant 0.1 percent per month, on average, since late 1997. Although farmers in some regions of the country are experiencing more prolonged weather problems, conditions in the major crop-producing areas of the Midwest still look relatively favorable, and it appears that aggregate farm production will be sufficient to maintain ample supplies over the coming year, especially in the context of sluggish export demand.

Credit and the Monetary Aggregates

Credit and Depository Intermediation. The total debt of U.S. households, governments, and nonfinancial businesses increased at an annual rate of 5¾ percent from the fourth quarter of 1997 through May of this year. Domestic nonfinancial debt now stands a little above the midpoint of the 3 percent to 7 percent range established by the FOMC for 1998. Debt growth has picked up since 1997, as an acceleration of private credit associated with strong domestic demand and readily available supply has more than offset reduced federal borrowing. Indeed, federal debt declined 1¼ percent at an annual rate between the fourth quarter of 1997 and May 1998, whereas nonfederal debt increased 8¼ percent annualized over the same period. The growth of nonfederal debt has slowed only slightly over the past several months.

Credit on the books of depository institutions rose at roughly the same pace as total credit in the first half of the year. Commercial bank credit advanced rapidly in the first quarter and at a more subdued rate in the second. This slowdown was especially acute in securities holdings, which had surged in both the fourth quarter of 1997 and the first quarter of this year. Responses to the Federal Reserve's May survey on bank lending practices suggest that the earlier runup in securities reflected the efforts of banks to boost returns on equity by increasing leverage; much of the rise in securities holdings was concentrated at banks that were constrained by recent mergers from using their profits to repurchase shares. Loan growth also slowed in the second quarter, although the various loan categories behaved quite differently: Real estate lending expanded most slowly in May and June, whereas business lending rebounded in those months after stalling out in March and April. Outstanding loans at branches and agencies of foreign banks declined in the second quarter, and survey responses identified an actual or expected weakening in the capital position of the parent banks as the primary impetus for a tightening of loan terms and standards.

Debt: Annual Range and Actual Level



The Report of Condition and Income (the Call Report) showed that banks' return on equity was about unchanged in the first quarter, staying in the elevated range it has occupied since 1993. Call Report data also indicated that delinquency and charge-off rates on commercial and industrial loans and on real estate loans remain quite low, while delinquency and charge-off rates on consumer loans have leveled off after their previous rise. Indeed, bank profits have benefited importantly in recent years from a low level of provisioning for loan losses. Nevertheless, bank supervisors have been concerned that intense competition and favorable economic conditions might be leading banks to ease standards excessively. They reminded depositories that credit assessments should take account of the possibility of less positive economic circumstances in the future.

The trend toward consolidation in the banking industry continued in the first half of the year. Some of the announced mergers involve combinations of banks and nonbank financial institutions, such as thrifts and insurance companies. Many of the mergers were designed to capitalize on the economies of scale and diversification of risk in nationwide banking; other mergers were undertaken to expand the range of services offered to customers. Although some observers are concerned that consolidation might raise banks' market power, greater national concentration in banking over the past several years has not increased banking concentration in most local markets.

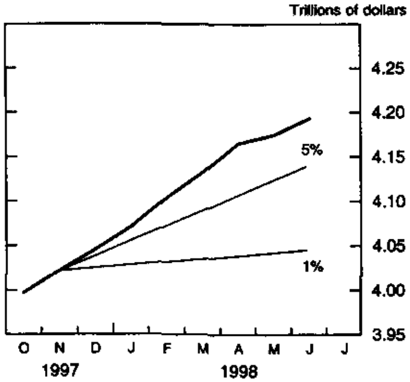
The Monetary Aggregates. The broad monetary aggregates grew more rapidly in the first half of 1998 than they did in 1997, although the pace of their expansion has slowed noticeably in recent months. M2 grew 7¼ percent at an annual rate between the fourth quarter of last year and June of this year, placing it well above the top of its 1 percent to 5 percent growth range. When the FOMC established this range in February, it noted that annual ranges represented benchmarks for money growth under conditions of stable prices and velocity behavior in accordance with its pre-1990 historical experience. In fact, nominal spending and income have grown more

Growth of Money and Debt
Percent

Period		M1	M2	M3	Domestic nonfinancial debt
Annual[1]					
1988		4.3	5.7	6.3	9.1
1989		0.5	5.2	4.0	7.5
1990		4.2	4.1	1.8	6.7
1991		7.9	3.1	1.2	4.5
1992		14.4	1.8	0.6	4.5
1993		10.6	1.3	1.1	4.9
1994		2.5	0.6	1.7	4.9
1995		−1.6	3.9	6.1	5.4
1996		−4.5	4.6	6.8	5.3
1997		−1.2	5.7	8.8	5.0
Quarterly (annual rate)[2]					
1998	Q1	3.0	8.0	11.0	6.2
	Q2	0.3	7.3	9.6	n.a.
Year-to-date[3]					
1998		0.9	7.3	9.8	5.8

1. From average for fourth quarter of preceding year to average for fourth quarter of year indicated.
2. From average for preceding quarter to average for quarter indicated.
3. From average for fourth quarter of 1997 to average for June (May in the case of domestic nonfinancial debt).

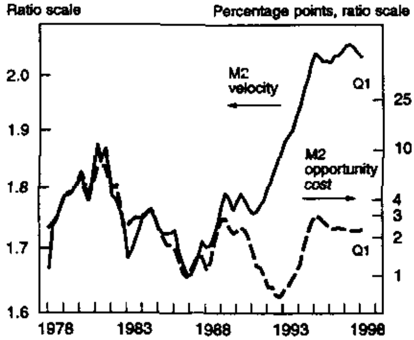
M2: Annual Range and Actual Level



rapidly than is consistent with price stability and sustainable real growth, and the velocity of M2 (defined as the ratio of nominal GDP to M2) has fallen relative to the behavior predicted by the pre-1990 experience.

For several decades before 1990, M2 velocity showed little overall trend but varied positively from year-to-year with changes in M2 opportunity cost, which is generally defined as the interest forgone by holding M2 assets rather than short-term market instruments such as Treasury bills. The relationship was disturbed in the early 1990s by a sharp increase in velocity; however, since mid-1994, M2 velocity and opportunity cost have again been moving roughly together, though not in lockstep. Indeed, velocity has declined recently despite almost no change in the standard measure of opportunity cost. The dip in velocity may be partly attributable to the flatter yield curve, which has reduced the return on longer-term investments relative to M2 assets—bank deposits and money market mutual funds. Money demand may also be bolstered by the efforts of households to rebalance their portfolios in the face of a booming stock market. By the end of 1997, households' monetary assets had ebbed to the smallest share of their total financial assets in many years, and households *may want to reduce the concentration of their assets* in relatively risky equities and increase their holdings of less volatile M2 assets. However, in spite of both the flatter yield curve and the rebalancing motive, flows into both bond mutual funds and stock mutual funds have been quite heavy this year.

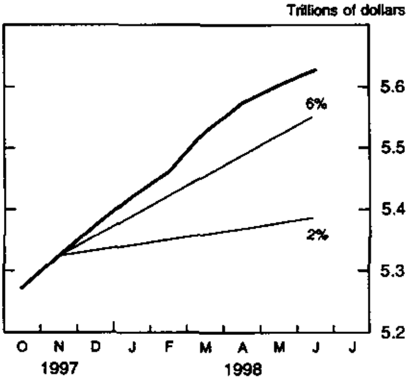
M2 Velocity and the Opportunity Cost of Holding M2



Note. M2 opportunity cost is a two-quarter moving average of the three-month Treasury bill rate less the weighted-average rate paid on M2 components.

M2 increased 7¼ percent at an annual rate in the second quarter, compared with 8 percent in the first quarter. A buildup in household liquid accounts in preparation for individual income tax payments substantially boosted money growth in April; the clearing of these payments depressed May growth by a roughly equal amount. At an annual rate, M2 increased about 6 percent on average over April and May and about 5 percent in June, suggesting a larger deceleration than is shown by the quarterly average figures.

M3: Annual Range and Actual Level



M3 grew 9¾ percent at an annual rate between the fourth quarter of last year and June, placing it far above the top of its 2 percent to 6 percent growth range. As with M2, the FOMC chose the growth range for M3 as a benchmark for growth under conditions of price stability and historical velocity behavior. The components of M3 not included in M2 increased 17½ percent at an annual rate over the first half of the year, following an even faster runup in 1997. Rapid expansion of large time deposits in the first quarter was driven importantly by strong credit growth at depository institutions. More recently, gains in this category have diminished as bank credit growth has slowed. Holdings of institutional money market mutual funds climbed more than 20 percent in each of the past three years, and that strength has mounted in 1998 as businesses' interest in outsourcing their cash management evidently has intensified. Because in-house management often involves short-term assets that are not included in M3, the shift to mutual funds boosts M3 growth.

M1 rose 1 percent at an annual rate between the fourth quarter of 1997 and June of this year. Currency expanded 6½ percent annualized over that period, a bit below its increase last year. Foreign demand for U.S. currency apparently weakened substantially in the first five months of the year, with an especially large decline in shipments to Russia. Deposits in M1 declined in the first half of the year owing to the continued introduction of "sweep" programs. M1 growth has been depressed for several years by the spread of these programs, which sweep balances out of transactions accounts, which are subject to reserve requirements, and into savings accounts, which are not. Depositors are unaffected by this arrangement because the funds are swept back when needed; banks benefit because they can reduce their holdings of reserves, which earn no interest. New sweeps of other checkable deposits have slowed sharply, but sweeps of demand deposits into savings deposits—an activity that has become popular more recently—continue to spread. Because many banks have already reduced their required reserves to minimal levels, the total flow of new sweep programs is tapering off, although it remains considerable.

The drop in transactions accounts in the first half of the year caused required reserves to fall 3¾ percent at an annual rate, a much slower decline than in 1997. The monetary base grew 5½ percent over the same period, as the runoff in required reserves was more than offset by the increased demand for currency.

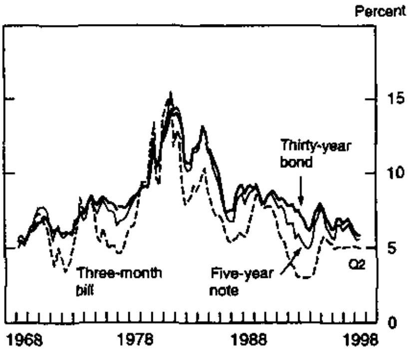
The substantial decline in required reserves over the past several years has raised concern that the federal funds rate might become more volatile. Required reserves are fairly predictable and must be maintained on only a two-week average basis. As a result, the Federal Reserve has generally been able to supply a quantity of reserves that is close to the quantity demanded at the federal funds rate intended by the FOMC, and banks have accommodated many unanticipated imbalances in reserve supply by varying the quantity demanded across days. Banks also hold reserve balances to avoid overdrafts after making payments to other banks. But this precautionary demand is more variable and difficult to predict than requirement-related demand, and it cannot be substituted across days. As required reserves drop, more banks will hold deposits at the Federal Reserve only to meet these day-to-day demands, reducing the potential for rate-smoothing behavior.

So far, however, the federal funds rate has not become noticeably more volatile on a maintenance-period average basis. This outcome has occurred partly because the Federal Reserve has responded to the changing nature of reserve demand by conducting open market operations on more days than had been customary and by arranging more operations with overnight maturity, thereby bringing the daily reserve supply more closely in line with demand. At the same time, banks have borrowed more reserves at the discount window and have improved the management of their accounts at Reserve Banks. Between 1995 and 1997, banks also significantly increased their required clearing balances, which they precommit to hold and which earn credits that can be applied to Federal Reserve priced services. Like required reserve balances, required clearing balances are predictable by the Federal Reserve and can be substituted across days within the two-week maintenance period. Going forward, the Federal Reserve's recent decision to use lagged reserve accounting rather than contemporaneous reserve accounting will increase somewhat the predictability of reserve demand by both banks and the Federal Reserve. Still, further declines in required reserves might increase funds-rate volatility. Moreover, one-third of the banks responding to the Federal Reserve's recent Senior Financial Officer Survey report that reserve management is more difficult today than in the past. One way to diminish these problems would be to pay interest on reserve balances, which would reduce banks' incentives to minimize those balances.

Financial Markets

Interest Rates. Yields on intermediate- and long-term Treasury securities moved in a fairly narrow

Selected Nominal Treasury Rates



Note. The twenty-year Treasury bond rate is shown until the first issuance of the thirty-year Treasury bond in February 1977.

band during the first half of 1998, centered a little below the levels that prevailed in the latter part of 1997. The thirty-year bond yield touched its lowest value since the bond was introduced to the regular auction calendar in 1977; it was also lower than any sustained yield on the twenty-year bond (the longest maturity Treasury security before the issuance of the thirty-year bond) since 1968. Meanwhile, the average yield on five-year notes in the first half of the year was the lowest since early 1994.

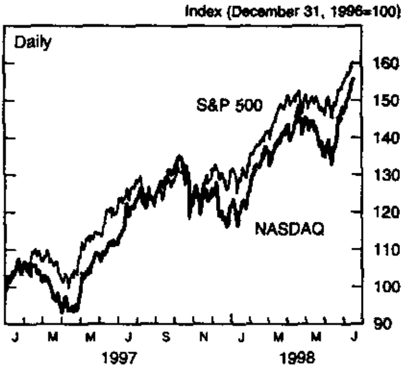
Several factors have contributed to the decline in intermediate- and long-term interest rates over the past year. For one, developments in the U.S. economy and overseas reduced expected inflation and, perhaps, uncertainty about future inflation. Between the second quarter of 1997 and the second quarter of 1998, the median long-term inflation expectation in the Michigan SRC survey of households dropped ¼ percentage point, and the average expectation in the Philadelphia Federal Reserve's Survey of Professional Forecasters fell almost ½ percentage point. Over the same period, the variance of long-term inflation expectations in the Michigan survey was halved. This greater consensus of expectations suggests that people may now place less weight on the possibility of a sharp acceleration in prices; a reduction in perceived inflation risk would tend to reduce term premiums and thereby cut long-term interest rates. A damping of expected growth in real demand here and abroad, triggered importantly by the Asian financial crisis, also has probably pulled rates lower, as has an apparent shift in desired portfolios away from Asia and, to some extent, from other emerging market economies. Lastly, diminished borrowing by the federal government has restrained interest rates by reducing the competition for private domestic saving and for borrowed funds from abroad.

Assessing the relative importance of some of these factors might be aided, in principle, by comparing yields on nominal and inflation-indexed Treasury notes. Between the second quarters of 1997 and 1998, the nominal ten-year yield fell more than 1 percentage point, whereas the inflation-indexed ten-year yield increased a bit. Unfortunately, the relatively recent introduction of inflation-indexed securities and the thinness of trading makes interpreting their yield levels and movements difficult. In particular, light trading may lead investors to view these new securities as providing less liquidity than traditional Treasury notes, and investors may value liquidity especially highly now in the face of uncertainty about developments in Asia.

The yield curve for Treasury securities has recently been flatter than at any point since the beginning of the decade. For example, the difference between the ten-year-note yield and the three-month-bill yield was smaller in the first half of 1998 than in any other half-year period since early 1990. In that earlier episode, the yield curve had been flattened by a sharp runup in short-term interest rates as the Federal Reserve tried to check an upcreep in inflation. In the current episode, short rates have held fairly steady, while long-term rates have declined significantly. Some of the current flatness of the term structure probably stems from the apparent reduction in term premiums noted above. But the flat yield curve may also reflect the expectation that short-term real interest rates, which have been boosted by the decline in inflation over the past year, will drop in the future. Supporting that notion, the yield curve for inflation-indexed debt has become inverted this year, as the return on the five-year indexed note has risen above the return on the ten-year indexed note, which exceeds the return on the new thirty-year indexed bond.

Equity Prices. Equity markets have remained ebullient this year. The S&P 500 composite index rose sharply in the first several months of 1998; it then fell back a little before moving up to a new record in July. The NASDAQ composite, NYSE composite, and Dow Jones Industrial Average followed roughly similar patterns, and these indexes now stand about 17 to 28 percent above their year-end marks. Small capitalization stocks have not fared so well this year, with the Russell 2000 index up about a third as much on net.

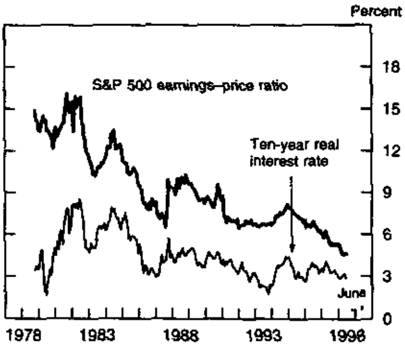
Major Stock Price Indexes



Note. Last observations are for July 17, 1998.

The increase in equity prices combined with the recent slowdown in earnings growth has kept many valuation measures well above their historical ranges. The ratio of prices in the S&P 500 to consensus estimates of earnings over the coming twelve months reached a new high in April and has retreated only slightly from that point. At the same time, the real long-term bond yield—measured either by the ten-year indexed yield or by the difference between the ten-year nominal Treasury yield and inflation expectations in the Philadelphia Federal Reserve's survey—is little changed since year-end. As a result, the forward-earnings yield on stocks exceeds the real yield on bonds by one of the smallest amounts in many years. Apparently, investors share analysts' expectations of robust long-term earnings growth, or they are content with a much smaller equity premium than the historical average.

Equity Valuation and Long-Term Interest Rate

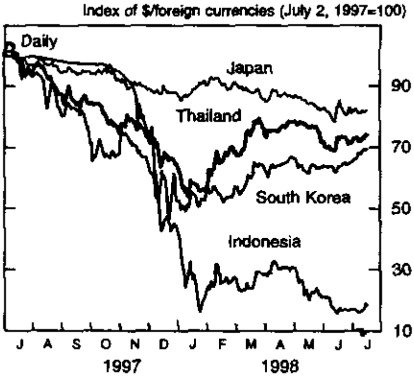


Note. The earnings–price ratio is based on the consensus estimate of earnings over the coming twelve months derived from the forecasts collected by I/B/E/S International, Inc. The real interest rate is the yield on the ten-year Treasury note less the ten-year inflation expectations from the Philadelphia Federal Reserve Survey of Professional Forecasters.

International Developments

Events in Asia, including in Japan, have continued to dominate developments in global asset markets so far in 1998. During the first months of the year, many financial markets in Asia appeared to stabilize, and progress in implementing economic and financial reform programs was made in most of the countries seriously affected by the crises. In early April, the agreement between Korean banks and their external bank creditors to stretch out short-term obligations was implemented, ending an interval of rollovers by creditors that was endorsed by the authorities in countries that had pledged to support the Korean program. Indonesia reached a second revised agreement with the International Monetary Fund (IMF) in April on a reform program, which was subsequently derailed by political strife and the resignation of the president in late May; the change in political regime was followed by calm, and a new agreement was reached with the IMF management in late June and approved by the IMF Executive Board on July 15.

Daily Value of Foreign Currencies

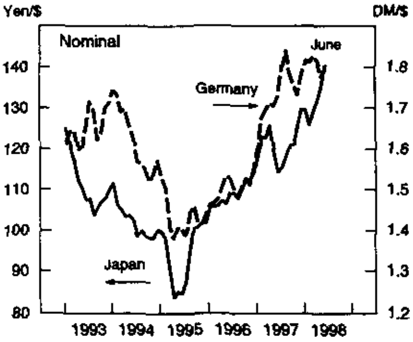


Note. Last observations are for July 17, 1998.

After rising sharply during the final months of 1997 through mid-January of 1998, the exchange value of the dollar in terms of the currencies of Korea, Indonesia, Thailand, and other ASEAN countries partly retraced those gains during February, March, and April. Since then, however, market pressures have again led to further sharp increases in the exchange value of the dollar in terms of the Indonesian rupiah while the dollar has changed little against most of the other Asian emerging-market currencies. Since the end of December, the dollar has declined, on balance, 24 percent against the Korean won and nearly 14 percent against the Thai baht and has risen moderately in terms of the Taiwan dollar and increased about 130 percent in terms of the Indonesian rupiah.

During the first weeks of the year, the dollar depreciated in terms of the Japanese yen as improved prospects elsewhere in Asia and market uncertainty regarding potential intervention by the Japanese monetary authorities lent support to the yen. Indications that significant measures for economic stimulus might be announced also put upward pressure on the yen. In February, the dollar resumed its appreciation with respect to the yen. The rise in the dollar was only temporarily interrupted by sizable intervention purchases of dollars by Japanese authorities in April. Upward pressure on the dollar relative to the yen intensified in late May and June. Renewed signs of cyclical weakness in the Japanese economy and lack of market confidence in the announced programs for addressing the chronic problems within the financial sector contributed to pessimism toward the yen. Persistent weakness in the Japanese economy and the yen, in turn, heightened concerns about prospects elsewhere in Asia; the lower yen adversely affected the competitiveness of goods produced in the Asian emerging-market economies and raised questions about the sustainability of current exchange rate policies in China and Hong Kong.

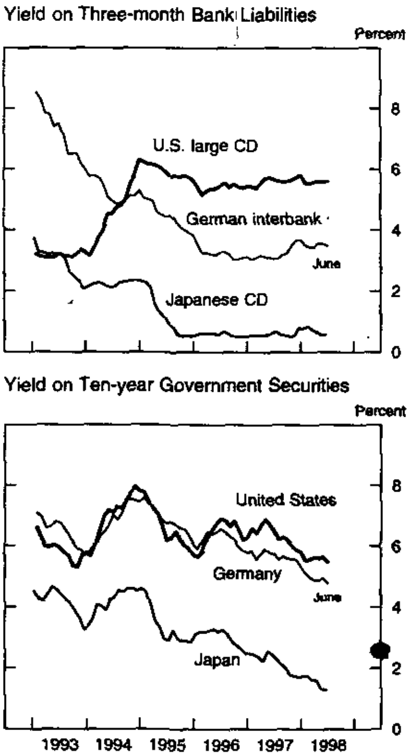
U.S. Exchange Rates with Japan and Germany



On June 17, the monetary authorities in the United States and Japan cooperated in foreign exchange intervention purchases of yen for dollars. This intervention operation was the first by U.S. authorities since August 1995. In announcing the market intervention, Treasury Secretary Rubin cited Japanese government plans to restore the health of their financial system and to strengthen Japanese domestic demand. He pointed to the stake of Asia and the international community as a whole in Japan's success. The yen rose somewhat following the exchange market intervention and has since partially given back that gain. In the wake of the recent election, which cost the LDP numerous seats in the upper house of the Diet and precipitated the resignation of Prime Minister Hashimoto, the yen changed little. On balance, the dollar has appreciated about 7 percent in terms of the yen since the end of December.

Equity prices in the Asian emerging-market economies have been volatile so far this year as well. These prices recovered somewhat in the first weeks of the year in response to the market perception that the crisis was easing; after fluctuating narrowly, they began moving back down in March and April, reaching new lows in June in Korea, Thailand, and Hong Kong. On balance, these equity prices have moved down about 25 percent (Singapore and Malaysia) to up about 20 percent (Indonesia) since the end of last year. Equity prices in Japan also rose early in the year on improved optimism but then gave back those gains over time with the release of indicators suggesting additional weakness in the Japanese economy. Since the middle of June, Japanese equity prices have rebounded on the perception that significant fiscal stimulus is now more likely. On balance, Japanese equity prices are up about 9 percent from their level at the end of last year. Japanese long-term interest rates continued through May on their downward trend that began in mid-1997, declining an additional 50 basis points during the first five months. Since then, long-term interest rates have retraced more than half of that decline, in part in response to the announcement of the plan for financial restructuring and in part in response to the outcome of the recent election, which heightened expectations of additional fiscal stimulus.

The Asian financial crises have resulted in a sharp drop in the pace of economic activity in the region. Output declined precipitously in the first quarter in those countries most affected, such as Korea, U.S. and Foreign Interest Rates



Indonesia, and Malaysia, and slowed in other Asian economies, such as China and Taiwan, that have suffered a loss of competitiveness and reduced external demand as a consequence of the crises. Data for recent months suggest that additional slowing has occurred and that the risk of further spread and deepening of cyclical weakness throughout the region cannot be ruled out. Depreciation of their respective currencies has led to acceleration of domestic prices in several of these economies, particularly in Indonesia and Thailand.

Real GDP in Japan also fell sharply in the first quarter, and output indicators suggest a further decline in the second quarter. Consumer price inflation remains very low. Japanese authorities have announced a series of fiscal measures that are expected to boost domestic demand during the second half of this year. In addition, officials have announced a package of steps directed at restoring the soundness of the financial sector, including (1) introduction of a bridge bank mechanism to facilitate the resolution of failed banks while permitting some of their borrowers to continue to receive credit, (2) measures to improve the disposal of bad bank loans, (3) enhanced transparency and disclosure by banks, and (4) strengthened bank supervision. These actions are intended to restore confidence in Japanese financial institutions and in the prospects for the economy more broadly.

In the other major industrial countries, economic developments so far this year have generally been favorable. The exchange value of the dollar in terms of the German mark has fluctuated narrowly and, on balance, is little changed since the end of December. Market perceptions that progress toward the start of the final stage of European Monetary Union (EMU) is going smoothly and signs of momentum in the U.S. and German economies resulted in little pressure in either direction on the exchange rate. The dollar also fluctuated narrowly against the U.K. pound with little net change so far this year. Moves to tighten monetary conditions in the United Kingdom lent support to the pound, countering some tendency for weak external demand to depress the currency. The Canadian dollar rebounded following a tightening of monetary conditions by the Bank of Canada on January 30. Since early March, however, it has tended to move down as market participants have come to believe that further upward shifts of official interest rates are unlikely and as weakness in global commodity markets, partly the result of reduced economic activity in Asia, have weighed on the currency. The exchange value of the U.S. dollar in terms of the Canadian dollar reached new highs in July and, on balance so far this year, has risen about 4 percent.

Long-term interest rates have declined and equity prices have generally risen strongly in European and Canadian markets this year. Despite signs of strengthening activity in Germany and other continental European countries and continued healthy expansion in the United Kingdom and Canada, long-term rates have moved down since December; long rates are about 60 basis points lower in Germany and less than half that amount lower in Canada. Shifts of international portfolios away from Asian assets and toward those perceived to be safer have probably contributed to rate declines in Continental Europe and in the United States. Stock prices have also continued to rise in Europe and Canada. Since December, the gains have ranged from about 40 percent in Germany and France to about 10 percent in Canada.

The pace of real economic activity improved somewhat in the first quarter in Germany and on average in the eleven countries slated to proceed with currency union on January 1, 1999.[2] Production and employment data for more recent months suggest continued expansion. Business confidence has firmed as progress toward EMU has continued. Domestic demand is becoming more buoyant in several of these countries, offsetting weakening of external demand arising from events in Asia. On average, inflation remains subdued within the euro area. In the United Kingdom and Canada, real output continues to expand at a relatively rapid rate. U.K. inflation threatens to exceed the government's target of 2½ percent, and the Bank of England raised its official lending rate 25 basis points in June in order to lessen price pressures. Consumer price inflation in Canada remains very low.

Events in Asia have spilled over to affect developments in Latin American countries. Declines in global oil prices have contributed to downward pressure on the exchange value of the Mexican peso. The peso declined sharply in terms of the dollar at the start of the year but then stabilized in February through May as Asian markets partially recovered. It depreciated further in May and June, resulting in a net decline of about 9 percent in terms of the dollar so far this year. The Brazilian exchange rate regime of a controlled crawl and the Argentine regime of pegging the peso to the dollar remain in place, and Brazilian short-term interest rates have been lowered from the very high levels to which they were raised when the Asian crisis intensified in late 1997. Equity prices in these three Latin American countries have been volatile, rising early in the year and giving back those gains since April. On balance this year, equity prices have declined about 10 percent in Mexico and Argentina and have risen about 8 percent in Brazil.

Real output growth remains strong in Mexico and Argentina, but the rate has slowed somewhat from last year's vigorous pace. In Brazil, economic activity has weakened more sharply, in part in response to the tightening of monetary conditions that followed the outbreak of the Asian crisis.

Lower global oil prices have combined with a poorly functioning domestic tax system to trigger a financial crisis in Russia. Russian officials have reached agreement with IMF management on a revised program that includes proposed increased funds from the IMF and other sources. To help finance this program, the General Arrangements to Borrow are being activated in light of the inadequacy of IMF resources to meet actual or expected requests for financing and a need to forestall impairment of the international monetary system. The General Arrangements to Borrow provide the IMF with supplementary lines of credit from the G-10 countries.

2. Those countries are Austria, Belgium, Finland, France, Ireland, Italy, Germany, Luxembourg, the Netherlands, Portugal, and Spain.

Chairman Greenspan subsequently submitted the following in response to written questions from Chairman Castle in connection with the July 22, 1998, hearing before the House Banking Subcommittee on Domestic and International Monetary Policy:

International Issues

You were recently in Japan and had a first-hand opportunity to assess the health of the Japanese financial system. Can you give the Subcommittee your perspective of the health of Japan's banks and financial institutions, and in addition comment on the dollar magnitude of the bad loan problem that remains to be resolved?

Japanese banks remain burdened with sizable portfolios of problem assets, and will not return to full health until these assets are removed from the banks' balance sheets and bank capital has been rebuilt. Japanese officials are currently debating the appropriate measures needed to bring about these results. As of the end of March, Japanese depository institutions reported nonperforming loans (past-due and restructured loans) of ¥35 trillion, which is 5 percent their total loans or 7 percent of Japan's GDP. Another measure of problem loans is credit exposures that are "classified assets" (assets for which full repayment is questionable, or would be questionable without additional risk management measures), which are reported at ¥88 trillion for Japanese depositories as of the end of March 1998, or 11 percent of their total credit exposure.

While in Japan, you also had a first-hand opportunity to assess the government's proposed "Total Plan" to reform the banking sector. While key details of the plan remain to be clarified, at this stage do you believe the bridge bank scheme is conceptually sound?

- **Does the policy thrust behind the bridge bank scheme correct the ills of the banking system, such as non-performing loans, excess capacity, competition from public financial institutions on private banking, and the lack of incentives for bank management?**

Do you believe implementation of the Total Plan would support the real economy in Japan? Why or why not?

The policy thrust behind the Total Plan includes the following measures:

• promote the restructuring of financial institutions and to ensure that sound borrowers of a failed bank would continue to receive credit by creating a mechanism for establishing a bridge bank, which would run the operations of a failed bank until the bank could be wound down, sold, or merged;

• promote the disposal of bad loans by encouraging the disposal of bank loans by the Cooperative Credit Purchasing Corporation (CCPC) and the Resolution and Collection Bank (RCB);

• improve transparency and disclosure by requiring all banks to report according to so-called "SEC-equivalent" standards; and

• strengthen bank supervision by mandating a long-overdue intensive inspection of the nineteen major banks.

Full and vigorous implementation of the Total Plan should over time help improve the economy in Japan. Banks will be more willing to lend when collateral values become more clear, after the collateral backing bad loans has been sold to the market. Banks will find borrowing less costly after uncertainty about the condition of Japanese banks has been reduced via improved disclosure and supervision.

Even in the best case scenario–rapid and appropriate financial system restructuring and permanent net tax cuts–isn't it likely that Japan's economy will remain weak for the second half of 1998 and into 1999? If that is the case, how can Japan possibly serve as an engine of Asian growth anytime in the near future?

Given the deep macroeconomic and structural problems facing the Japanese economy, coupled with declining confidence of Japanese households and firms and the resulting contraction of economic activity, it seems unlikely that Japan will serve as an engine of growth anytime soon. Nevertheless, aggressive action to address the bad-loan problems, reform the banking system, and restructure the economy more broadly should prepare the way for sustained private-demand-led growth in Japan. Although the benefits of such policies will likely not be immediate, these actions are necessary to strengthen the Japanese economy in the medium- to long-run and to make Japan an engine of growth–not only for Asia, but also for the rest of the world.

What is the nature and severity of risk to the U.S., regional, and global economy if Japan is unable to implement the kinds of reforms that restore domestic and international confidence in its financial system?

Weakness of consumer and business confidence, stemming to a considerable extent from the large and growing bad debt problems in the Japanese banking system are at the core of Japan's economic problems today. Failure to deal effectively with these problems will make it very difficult to engender a full and lasting recovery in Japanese economic activity. Continued weakness in Japanese domestic demand will depress demand for imports from elsewhere in Asia as well as from the United States, weighing on economic recovery in Asia as well as on the U.S. trade deficit. Failure to restore the health of

Japan's banking system also has potentially negative implications for financial intermediation elsewhere in Asia and in the United States, where Japanese banks have been important players in the recent past.

As you know, a debate has emerged between economists as to the principal causes of the Asian crisis. At the risk of oversimplification, one school attributes the crises largely to ample global liquidity in combination with weak national financial systems and the corrosive impact of "crony capitalism." The other school asserts that the Asian economies were fundamentally sound and that the irrational herd instincts of market participants combined with the pernicious influence of short-term capital flows and poor IMF policy advice to cause the crisis. Could you explain to the Subcommittee in greater detail why you believe the explanation of the first school is more persuasive than the second?

During the hearing, Congressman Metcalf raised a similar question, and I responded that I think the first view is more right than the second.

To elaborate, each of the two "schools" identified has some valid arguments. Although neither school is entirely correct, the weight of evidence would seem to favor attributing primary responsibility for the financial troubles in Asia to the inability of domestic financial systems in the borrowing countries to cope efficiently and prudently with international capital flows, the scale of which had grown substantially in recent years.

When assessing the debate about the causes of the "Asian crisis," it is important to distinguish among the various economies involved; each economy's problems and circumstances are unique, albeit with some common elements. The differing circumstances in each economy mean that some evidence can be marshaled for just about any argument regarding the causes of the problems in Asia.

However, there would appear to be two very important common elements in the experiences of the Asian economies that have been the hardest hit so far:

(1) these economies relied greatly--and excessively, as is now clear--on foreign borrowing, especially short-term borrowing; and

(2) the domestic financial infrastructures, including bank supervision and regulation, in these economies were inadequate, with the abuses of so-called "crony capitalism" too often being a cause or a consequence of these structural shortcomings.

In some cases, macroeconomic policies also were not consistent with domestic and external stability, and exchange rates were becoming increasingly out of line with economic fundamentals, although perhaps not alarmingly so.

On the other hand, the Asian economies had many strengths as well, including vibrant export sectors, relatively low rates of inflation, and very high savings and investment rates, although, to be sure, not all of the investments had been in sound projects.

During the successive waves of market sell-offs in various Asian economies, market participants have been reacting to real concerns regarding the profitability of their various investment positions. However, to an outside observer, it would seem that in at least some instances markets have over-reacted. Certainly some Asian currencies have reached depreciated levels that would seem to be far removed from what standard economic analysis would indicate to be their fundamental values.

The international community, centering its efforts on the IMF, appropriately has stepped forward to contain the potential damage both to the individual Asian economies and to the international financial system more generally.

With regard to formulating the appropriate course of action in each Asian economy, the IMF and the international community more generally are clearly facing difficult and largely unprecedented situations and are required to make difficult decisions. Market forces have made exchange rate pegs untenable. Fundamental structural adjustments are necessary but will take time and much effort to accomplish. Structural adjustments also entail fiscal costs which must be financed in a non-inflationary manner. Taking into account such factors as the adjustment and stabilization processes that have developed over the past several months, the IMF has shown constructive flexibility in its policy advice to the troubled borrowing economies.

Chairman Greenspan subsequently submitted the following in response to written questions from Congressman Bentsen in connection with the July 22, 1998, hearing before the House Banking Subcommittee on Domestic and International Monetary Policy:

1. Absent an increased assessment on member nations, including the proposed $17.9 billion from the United States, the IMF has begun to draw on its General Arrangements to Borrow account. In addition to the GAB, the IMF also holds gold reserves valued at approximately $40 billion. Do you believe the IMF has sufficient resources to meet its existing and proposed obligations in Asia and Russia? Is the use of GAB funds and gold reserves for these purposes, in your opinion, sound fiscal policy for the IMF?

Taking into account the IMF's already existing obligations, including committed but undisbursed credits under its programs for Korea, Indonesia, Thailand, and Russia, IMF liquidity has been diminished to such an extent that it would be very difficult for the IMF to provide adequate support in the event that additional major countries meet with significant external financial distress. Measures of the IMF's liquidity--the fraction of its liquid resources that are available for future lending--currently are at less than half of their level at the end of 1996, before the Asian financial crisis, and are well below their long-term average as well. An adequate level of liquidity is necessary not only to finance additional programs, if they are needed, but also to allow for the possibility that one or more creditor countries might encounter financial problems requiring them to withdraw some of their reserve positions in the IMF. An increase in the amount of resources available to the IMF would help to restore its liquidity and provide it with greater flexibility in being able to respond to future financial problems. A more important consideration at this time in my view is the fact that adding to the IMF's financial resources would provide appropriate insurance against the risk of major disruption of the global economy and financial system.

The use of GAB funds on a sustained basis or its gold reserves are not the answer to the IMF's liquidity problem. Resources available through the GAB are intended to be used only in response to problems with systemic implications for the international financial system, and hence could not be used to finance many of the programs supported by the IMF. The IMF's gold reserves provide crucial backing of its financial position, and cannot be sold without approval of 85 percent of its members' voting power.

2. In your testimony, you state that the Asian economic downturn is responsible for the fall in oil prices and such prices should rebound over time. Are you asserting that the Asian crisis is the only reason for falling oil prices?

Crude oil prices have declined by about 33 percent since October of last year. One can reasonably attribute about half of this decline to the reduction in oil demand in Asia as a result of the economic crisis in that region. Several other factors contributed to the decline: last winter's warm weather, which reduced demand for heating oil, OPEC's decision last November to increase crude oil production, and the depreciation of most European currencies against the dollar, which raised the price of oil and reduced demand for it in that region. The combination of these factors led to a runup in the level of crude oil inventories that has continued to restrain prices.

3. With deflated oil prices and the drought in many agriculture states such as Texas, is the Federal Reserve projecting any additional weakness in either the national economy or regional economies as a result? Is such weakness already accounted for in your current projections?

We in the Federal Reserve have been aware of the developments to which you refer. Although there are a variety of causal factors behind them, the slump in Asia and the appreciation of the dollar have played a significant role. The oil and agriculture sectors have been among the hardest hit by the Asian crisis; although the weakness in prices of commodities has blunted inflationary pressures and been a boon for the purchasing power of consumers, many producers have suffered appreciable contractions of their revenues. As I noted in my testimony, we have attempted to take these forces into account in our forecast, but uncertainties remain considerable and we shall have to continue monitoring developments closely to make sure that our assessments are correct.

4. As you know, some including House Budget Committee Chairman John Kasich, have proposed using projected future budget surpluses for tax cuts totalling $700 billion. Given your statements expressing concern about the strength of the economy and potential wage and price pressure, would the Fed view such cuts as potentially creating too much stimulus for a growing economy? Would such a cut raise the specter of the Fed imposing contractionary monetary policies such as rate hikes to keep the money supply within projected bands and inflationary pressures under wraps?

It is fair to say that, up to now, the U.S. economy has not been suffering from a lack of domestic private demand. Far from it, as the recently released second-quarter GDP figures once again attested. Under the circumstances, as I've remarked, it is quite fortunate that there has been a degree of fiscal restraint at the federal level. The swing into budgetary surplus has not only helped to mute inflationary pressures but has freed up domestic saving to help finance productivity-enhancing business investment. I would hope that we could sustain that direction, preserving the projected--and not yet fully realized--surpluses, especially given the longer-range budgetary problems associated with the interaction of our entitlement programs and the aging of the population over the coming decades. I would not want to anticipate the direction of monetary policy, which depends on the overall economic picture, rather than any one element.

5. On page 17 of your report, the Fed states that "employer payments for health insurance have picked up moderately in recent quarters after having been...flat." Is the Fed foreseeing an uptick in health care costs along the lines of the late 1980's?

We have already seen an acceleration of employer costs for health insurance. According to the Bureau of Labor Statistics' Employment Cost Indexes for private industry, health insurance costs rose about 2-1/2 percent over the past year, versus about 3/4 percent in the year ended June 1997. Reports on the emerging trend in health insurance costs have been somewhat inconsistent, but on the whole they point to at least some further pickup. A return to the huge annual increases of several years ago, however, is not commonly foreseen. Some analysts argue that the changes in market structure--the shift to various kinds of managed care arrangements among other things--are a lasting damping force on increases in the relative price of health care; and it is thought that employers are more focused than they once were on containing health insurance expenses along with other costs (implying, among other things, that they will be more resistant to premium increases and more inclined to pass increases on to employees in one way or another).

6. What measures, if any, is the Fed proposing to address liquidity concerns in the banking system as a result of the Y2K issue?

The Federal Reserve has several means to meet unusual demands for liquidity at the century date change or at any other time. Open market operations are used to supply sufficient reserves to ameliorate any overall pressures in money markets. And, individual depository institutions have access to the Federal Reserve's discount window to meet liquidity needs that cannot be accommodated through normal channels.

We are working closely with other bank and thrift supervisors, depository institutions, and other market participants to assure as smooth a century date change as possible in U.S. financial markets, but we recognize the considerable uncertainties involved and hence the potential for unusual liquidity needs. Along with the other supervisors of depository institutions, we will be encouraging depositories to have contingency plans to deal with disruptions to their usual sources of liquidity. As an element of such plans, depositories may wish to execute necessary agreements and make collateral arrangements to facilitate discount window borrowing should that be necessary; the Reserve Banks will be working with depositories to help them with these preparations.

STATEMENT OF DAVID A. SMITH
DIRECTOR OF PUBLIC POLICY, AFL-CIO
BEFORE THE HOUSE BANKING COMMITTEE
ON THE HUMPHREY-HAWKINS HEARING
July 23, 1998

The AFL-CIO appreciates the opportunity to submit this statement for the record of today's Humphrey-Hawkins hearing. All working Americans and their families have a high stake in the achievement of the Humphrey-Hawkins Act's full employment targets. It is good news for America's workers that the nation's unemployment rate is edging closer to our historic full employment targets than at any other time since this landmark legislation was adopted in 1978.

While the reduction in unemployment over the last few years is gratifying, it is by no means guaranteed that this favorable trend will continue, or that the Humphrey-Hawkins target of a national unemployment rate no higher than four percent will actually be achieved. Much will depend on economic policy decisions, of which none will be more important than the monetary policy decisions of the Federal Reserve's Open Market Committee.

We urge Chairman Greenspan and his FOMC colleagues to use the tools of monetary policy to guide the economy toward its full employment potential. With inflation low and declining while unemployment has been decreasing, four percent unemployment should no longer be dismissed as an unrealistic goal.

The most serious threat to reaching that goal are the shock waves set off by the severe financial and economic crisis which has enveloped much of East Asia, and which apparently is spreading to other parts of the world, including Russia.

No serious observer would deny that the movement of a tidal wave of capital from East Asia and elsewhere to the relative safety, security and high returns of U.S. financial markets has been a hallmark of the current financial crisis. In an effort to stem the outflow, defend their currencies and satisfy the austerity conditions imposed by the IMF, the countries hit hardest by the crisis have been forced to boost their domestic interest rates to astronomical and punishing levels.

Meanwhile, the largest economy in Asia and the second largest in the world, Japan, is caught in a deepening economic crisis. In an effort to jump start its stalled economy, Japan's central bank has cut interest rates to record lows. Low interest rates, however, have done little to stimulate Japan's economy, in part because a banking crisis has curtailed lending but also in part because capital has left the country in pursuit of higher returns on investment in the U.S. The exit of capital has battered the yen, making Japanese exports hyper-competitive and stimulating the outflow of even more capital.

The human costs of East Asia's financial crisis are staggering. In Indonesia, Thailand, South Korea and elsewhere bankruptcies and unemployment are mounting, and the worst is yet to come. Rudimentary or nonexistent social safety nets in these countries mean that the unemployed are left largely to their own devices. Beyond the human tragedy, the inadequate safety net worsens these economies' downward spiral, as the unemployed are forced to curtail their purchases when they lose their jobs. Deficit spending to mitigate the crisis is out of the question, partly as a result of IMF austerity conditions and partly because of the need to prevent further exodus of capital.

One obvious step which the U.S. could and should take to ease Japan's and the East Asian economic crisis is to lower our interest rates in order to slow down the torrent of capital pouring into our financial markets. Lower U.S. interest rates in and of themselves will not resolve the crisis, but they would clearly ease it. Compared with the cost of IMF bailouts both to U.S. taxpayers and to the people of East Asia who are bearing the burden of economic austerity, lower U.S. interest rates are a dirt cheap policy alternative.

The crisis in Japan and the rest of East Asia has already begun to have a negative impact on the U.S. economy. In May, the nation's trade deficit in goods and services increased to $15.7

billion, an all-time monthly high. For the first five months of 1998, the U.S. trade deficit in goods with the Pacific Rim countries totaled $59 billion, a 43 per cent jump from the first five months of 1997.

Much of the recent deterioration in the nation's trade position is attributable to declining U.S. exports, brought about by the collapse of currencies and bank lending in Asian countries which, as a result, can no longer afford or finance the purchase of U.S.-made products. Declining exports and accelerating imports have begun to hit U.S. manufacturing employment, which has been weak for most of this year. In May and June, this weakness yielded to outright employment declines totaling 51,000 jobs.

Evidence is mounting, moreover, that the worsening of the nation's trade position and the declines in manufacturing employment may already have triggered a marked slowdown or even contraction in the U.S. economy.

In view of the time lag between changes in monetary policy and their impact on the economy, it would be far better to lower U.S. interest rates now than to wait for the East Asian economic crisis and the weakness in the U.S. economy to worsen. There is little downside to lowering U.S. interest rates. Inflation remains tame, as the June figures for both the CPI and PPI attest. Now is the time to lower interest rates, to ease the East Asian economic crisis and keep the U.S. economy on course to, at long last, reaching the Humphrey-Hawkins Act's full employment goal.