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.)

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

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CONDUCT OF MONETARY POLICY

Tuesday, July 24, 1990

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Neal, Representatives Barnard, Hoagland, McCollum, Leach and Bunning.

Also present: Representatives Weiss, Schumer, Neal of Massachusetts, and Ridge.

Chairman NEAL. I would like to call this meeting of the subcommittee to order.

Today we welcome the Chairman of the Board of Governors of the Federal Reserve System for the presentation of the Federal Reserve's monetary policy report to Congress.

Since this report was released last week, we, the public and the press, have already had an opportunity to look it over. From what I have seen, general reaction to this report has focused on two issues: The recent alleged easing by the Fed and the indication that the Fed might well undertake a more significant shift in policy if we reach agreement on a major reduction in budget deficits.

These issues are certainly important and relevant, and I will be posing some questions to the chairman about them. At the outset, however, I would like to call attention to the enduring question we should always be asking the Fed.

In October of last year, Chairman Greenspan appeared before this subcommittee to endorse my legislation, H.J. Res. 409, directing the Federal Reserve to eliminate inflation over the next 5 years and then pursue monetary policies that maintain price stability or zero inflation. Since this legislation has not yet been enacted into law, it is, of course, not yet binding on Federal policy in a legal or formal sense.

Nonetheless, Chairman Greenspan has endorsed it as have the presidents of the Federal Reserve Banks. It is a policy which we can and should expect the Fed to pursue, even if it is not yet a legal requirement.

It can't be said often enough that the way, the only way to ensure low interest rates is to establish and maintain low or zero inflation.

If we would establish and maintain zero inflation, we could expect long-term Treasury rates to be 3 or 4 percent, we could expect short-term rates to be even lower, we could expect mortgage rates at about 6 percent, we could expect consumer and business rates at about half of today's level, we could significantly reduce the budget deficit by reducing that amount we pay for interest, and we would have established the essential condition for maximum sustained economic growth, maximum sustained employment. We would have established the essential condition for maximization and therefore investment, higher productivity in our economy, higher competitiveness in world trade.

The one policy of zero inflation gives us essentially the other policies that we want from monetary policy. That being so, the first inquiry we should pose at these hearings on the Fed's monetary policy report is simple: What progress have you made toward zero inflation? Does your outlook for future policy over the next year or so anticipate progress towards zero inflation? What do you see in current economic data and in your forecasts that indicate we will or will not make progress toward zero inflation? If there has been no discernible progress, why not? These are precisely the questions that we will be asking of the chairman when he has finished his testimony.

I will, moreover, want to ask him about the other two issues that seem to dominate this report, the recent so-called credit crunch easing and the relevance of a budget deal for monetary policy and to relate these to our shared long-term goal of eliminating inflation from the American economy.

It is always a great pleasure to have the distinguished Chairman of the Federal Reserve Board here with us. Before calling on him, however, I would like to ask if there are other Members who have opening statements.

Mr. McCollum. I do, Mr. Chairman.

Chairman Neal. Mr. McCollum.

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

Always glad to have you with us, Mr. Greenspan. We have over the years gotten to know you and your philosophy and your steady hand down at the Federal Reserve with great respect and admiration.

I am always amazed when you come to these hearings how much attention it not only generates but if you make one little word one way, the stock market goes up like that or down like this, and it is just remarkable to me because it seems to me that you have made your policies so clear to us, and they have not deviated to any significant degree that I can determine since we have been holding these hearings. You have been steady and very forthright in your determination to control inflation and to help guide the other Members of the Open Market Committee who obviously do the voting on all this to that end, and to attempt to balance that out with the growth in the economy that we have to have, and all of that in the face of these deficits that we don't control very well up here on the fiscal side of the matter.

So I know today you are going to elaborate on some of this and probably follow up with questions that are raised as a result of the last time you talked to a body on a subject like this, but in the long run and over the period that we have known you, we know that it is a very steady course, a lot of work goes into the market decisions that are made, a lot of factors to be considered.

Our committee will debate sometimes whether you and not you yourself but the Open Market Committee perhaps is considering all the right factors at the moment, but these are very big judgment calls, and on the whole we think that you have done an admirable job of balancing those interests, even if we might disagree from time to time with individual decisions.

So we thank you for coming up, thank you for your patience, and wish you well in juggling all of this as you continue to come before these hearings.

Thank you.

Chairman NEAL. Thank you, sir.

Mr. Barnard.

Mr. BARNARD. I have no opening statement.

Chairman NEAL. Are there other Members who have opening statements?

Mr. Neal.

Mr. NEAL OF MASSACHUSETTS. Thank you, Mr. Chairman.

I want to congratulate you for having Mr. Greenspan here this morning, and certainly the idea that you have broached moving the nation in the direction of zero percent inflation is one of the most stimulating I have witnessed since I have been a Member of the House.

I would hope that Mr. Greenspan this morning might speak specifically in his comments to the credit crunch in New England, real or perceived. There are many complaints that I receive, particularly from the small business sector, almost on a daily basis now about their inability to secure credit.

I would hope that you might have the opportunity this morning, Mr. Greenspan, to speak specifically to that issue.

Thank you, Mr. Chairman.

Chairman NEAL. Are there other Members who would like to be recognized at this time?

If not, Mr. Chairman, we will put your entire statement in the record and ask that you proceed as you will with your testimony.

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

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

When I came before this committee in February, I characterized the economy as poised for continued moderate expansion in 1990, and in large measure developments so far this year appear to have borne that statement out.

There are a number of plusses and minuses in the economic picture by sector and by region, but on balance the economy still appears to be growing, and the likelihood of a near-term recession seems low.

The unemployment rate has remained very low by the standards of the past 20 years, but the rate of increase in wages appears to have leveled out from its earlier upward trend, and the core rate of inflation in consumer prices, which picked up sharply in the first quarter, has moderated in recent months.

The June CPI figure, which was boosted by some technical factors, added a note of caution to this assessment, and a continuation of inflation at last month's pace clearly would be very troubling.

In 1990 Federal Reserve policy has continued to be directed at sustaining the economic expansion while making progress toward price stability. Ultimately the two go hand in hand. A stable price level sets the stage for the economy to operate at its peak efficiency while high inflation inevitably sows the seeds of recession and wrenching readjustment.

This year, which has been marked by dramatic changes in the flow of funds through depository institutions, Federal Reserve has been paying particularly close attention to conditions in credit markets. Evidence of a tightening of terms and reduced availability of credit has gradually accumulated to the point where it became apparent in recent days that some action by the monetary authority was warranted.

A number of indicators have been pointing in this direction, including the behavior of the monetary aggregates, suggesting that the degree of financial restraint in train might be greater than anticipated or than appropriate to the evolving economic situation. This restraint is a function of developments in the credit markets independent of monetary policy.

The recent decline in the Federal funds rate to 8 percent as a consequence of our action to reduce slightly the pressures in reserve markets represents an effort to offset the effects of greater stringency in credit markets.

M2 growth slowed sharply over the first half of 1990, owing in some measure to the restructuring of financial flows. Although the closing of insolvent thrifts by the RTC did not directly affect M2, the availability of huge blocks of deposits to the remaining thrifts and banks lessened those institutions' needs to raise rates to draw in funds, contributing to an unusual degree of inertia in the pricing of retail deposits.

The link between the RTC's activities and the meager growth this year in the broader monetary aggregate, M3, is clearer. The RTC closed down a very large number of S&Ls, taking many of those institutions' assets on to the government's balance sheet, and thereby effectively reducing the overall funding needs of the depository system.

The weakness in the monetary aggregates in part signals a change in the behavior of the depository institutions with potential for affecting overall credit provision. The conservative pricing of retail and wholesale deposits represents one aspect of their efforts to widen profit margins.

In light of concerns about their capital positions, banks and thrifts also have reined in lending activity and imposed stiffer terms on loans. The change in credit supply conditions may have significant implications for borrowing, spending, and policy.

I would not call this change a credit crunch, as those words connote a contraction of lending on a major scale with many borrowers effectively shut out of credit markets, regardless of their qualifications.

We are not seeing symptoms of that kind of widespread classic crunch as in the past when deposit rates ceilings or usury ceilings limited the market's ability to adjust and forced cutoffs of credit.

But what do we observe? The evidence on this score continues to grow. Numerous reports indicate that depository institutions and other lenders have become more selective in extending credit conditions has taken various forms, including tougher standards for credit approval, higher collateral requirements, increases in interest rates, and in some cases loans have been simply unavailable. But on some types of credit, including residential mortgages, changes in price and non-price terms appear to have been relatively minor.

These types of obligations account for a major share of the credit extended in the economy and hence the slowing of depository credit and the sluggish behavior of the monetary aggregates while indicative of some tightening of credit likely overstate the impact of the depositor's behavior on economic activity.

No doubt a sizable portion of lenders' increased reluctance to commit funds for certain purposes reflects a natural and healthy reaction to a slowdown in growth, as the economy moves closer to capacity constraint. But there is more to it than that.

Through one avenue or another, the change in credit standards has its roots in part in the excesses of the 1980's. Large losses on soured loans and the financial markets' distaste for providing additional capital to the institutions taking these losses have interacted with rising capital requirements for banks and thrifts. This interaction has resulted in strong incentives for depository institutions to conserve capital.

Partly as a result, the growth of aggregate debt has come down into closer alignment with the expansion of nominal GNP. This process, which reflects a somewhat more cautious approach on the part of borrowers as well, is not an aberrant restrictive phase in the life of the financial system, but rather a return to what had been the norm prior to the 1980's.

To be sure, when you go from excess credit creation to normal, it can feel like a tightening, and in that sense credit conditions have tightened. Many of the loans made during the 1980's should not, by historical standards of creditworthiness, have been made. As standards reverted closer to normal, those weaker borrowers have been finding it far more difficult to access credit.

In addition, however, depository institutions appear more recently to be lending with greater caution in general. As a result, even creditworthy borrowers may have to look harder for a loan, put up more collateral, or pay a somewhat higher spread. For the nation as a whole, the tightening of credit standards will leave the financial system on a sounder footing and contribute to economic stability in the long run. Nevertheless, in the here and now, the tightening is beginning to have very real, unwelcome effects.

It is difficult to discern the dividing line between lending standards that are still healthy and those that are so restrictive as to be inconsistent with the borrower's status and the best interests of the lender in the long run. In recent weeks, however, we may have slipped over that line.

As best we can judge, the change in credit conditions currently is exerting a slight additional degree of restraint on the economy. The process of credit restraint may not have reached completion, and some of its effects may not yet have been felt; hence it will require continued scrutiny. However, the tightening should eventually unwind as displaced borrowers find alternate sources of funds and as the banking system rebuilds its capital.

At its meeting earlier this month, the Federal Open Market Committee reaffirmed the 1990 range of 3 to 7 percent it had set for the growth of M2. In view of changing credit flows, a slow rate of expansion in M2 seems consistent with continued moderate growth in output, but any pronounced weakness in the aggregate that drops it below this range might represent greater monetary restraint than is desirable this year.

Looking ahead to 1991, the committee lowered the M2 range by a half a percentage point on a provisional basis, consistent with the continuation of measured restraint on aggregate demand, a necessity in the containment and ultimately elimination of inflation.

FOMC members and other Reserve Bank presidents generally foresee the policy embodied in the money ranges as leading to both sustained growth and diminished inflation in the period ahead. For 1990 their expectations center on an inflation rate in the 4.5 to 5 percent range, with real GNP growth about 1.5 to 2 percent, but with this year's slow growth helping to relieve pressures on resources, expectations for 1991 incorporate both somewhat lower inflation and somewhat higher real growth at a rate closer to that of growth in the potential output.

In judging the outlook for the economy over the next year and a half, one source of uncertainty is fiscal policy, but the determination displayed by the Congress and the administration in their efforts to come to an agreement on cutting the deficit has been enormously heartening to all who are concerned about the long-run health of the U.S. economy.

As a nation, we have been saving too little and borrowing too much for too long. Significant progress on the Federal deficit would be an important step in rectifying this situation.

Major substantive credible cuts in the budget deficit would present the Federal Reserve with a situation that would call for a careful reconsideration of its policy stance, what adjustment might be necessary, and how it might be timed cannot be spelled out before the fact. The actions required will depend on the constellation of other influences on the economy, the nature and magnitude of the fiscal policy package, and the likely timing of its effects.

I can only offer the assurance that the Federal Reserve will act as it has in the past to endeavor to keep the economy expansion on track.

Moreover, concerns that monetary policy would be unable to offset undesirable macroeconomic effects on a budget pact are, I believe, largely unfounded. In the final analysis, a major cut in the budget is unquestionably the right thing to do.

It is well past time to reduce the Government's draw on credit markets and to free up more resources for enhancing investment and production by the private sector. In this way, fiscal policy, by augmenting national savings, will be doing its part to promote maximum sustainable economic growth. With monetary policy similarly keeping sight of its long-run goal of price stability, the two together will have set a favorable backdrop for vibrant and enduring economic growth.

Thank you, Mr. Chairman.

Chairman NEAL. Thank you, Mr. Chairman.

[The prepared statement of Mr. Greenspan can be found in the appendix.]

Chairman NEAL. Now, I quite agree with you about the need to reduce the budget deficit, and I think everyone does. You see the difficulties that Congress and the administration seems to have with it. I know you have expressed yourself on this point a number of times, but I wonder if you would do it one more time.

In your judgment, and the reason I ask you this question, I just want to say, is because you have the best economists, I think, that there are around Washington and among the best in the world, and you have lots of them, and I think you can be a source of great economic wisdom for all of us.

Now I want to ask you about in lowering the budget deficits, I know that you would prefer cuts in spending to tax increases, but do you think cutting the budget deficit is so important that we ought to accept some tax increases to do that?

Mr. GREENSPAN. Well, Mr. Chairman, I consider the issue so important that even though there are divisions on the economic impact of how one cuts the budget deficit, I think we should be less concerned at this stage with the actual process, so long as it is reasonably balanced, than we should be with the details.

As I have indicated to this committee many times in the past, I would far prefer that the heavy emphasis be on the spending side rather than on the tax side on the grounds that I think it is a more credible deficit reduction and one that clearly would endure for a very substantial period into the future. But there is no question that if a cut in the budget deficit can be made enforceable by the actions which I gather the budget summit participants are discussing, then I would say we would need to have somewhat less concern about the longer-term issue. But I certainly would want to emphasize that the crucial aspect of this budget agreement is that it be credible and enforceable.

If the markets do not respond favorably, they are, in effect, saying that they do not believe that the deficit package is either credible or enforceable, and I think that the budget summit fully understands that and is working in the appropriate direction.

Chairman NEAL. Now, the stock market, as you know, went down 100 points yesterday and came back up some, but closed down significantly on heavy volume with the losers outnumbering the gainers significantly, and I have read a number of reports as to why that might have happened.

It seems to me, though, that the predominant view is that there are renewed fears of inflation, and as I understand how these markets work, there is probably nothing worse for high interest rates, for bad market conditions than renewed inflation, and clearly there is some fears, it seems to me clear that there is some fears out there that that is what is going on.

It seems to me that some of that is being caused by this idea that there is some kind of an agreement that if the Congress, the administration can significantly reduce budget deficits, that the Fed then is going to ease on the monetary side.

Now, I personally think that would be foolish. The idea of reducing budget deficits, the economic benefits occur in terms of increased savings and investment in the private sector, it seems to me, and if the Fed were to offset that by stimulating consumer spending by lowering short-term interest rates, it would seem to me to be very counterproductive.

Could you comment on that. Do you take it that if we make some progress on reducing the budget deficit, that that would be a sign for the Fed to start easing in some way? Does it run the risk of more inflation and stimulating consumer spending?

Mr. GREENSPAN. No, I think as I have indicated previously both to this committee and to your counterparts in the Senate fairly recently, the crucial issue is whether or not this budget-cutting exercise is credible and enforceable, and if it is, in my judgment I think we will see a very significant response in the financial markets.

To the extent that that occurs, we would be affected and would respond accordingly, but it would certainly be in the context of not inducing inflationary pressures because if that were to occur, then the tremendous benefits from the budget-cutting exercise would be rapidly dissipated, and we could largely offset the extraordinary benefits which I see as a consequence were a policy to be inappropriate to the particular actions that were taken, and in this sense, I think we have to very carefully watch how the markets behave because it is ultimately market structures that will determine exactly how successful this transition from a very large budget deficit to hopefully something resembling a surplus will materialize.

I must say, Mr. Chairman, in answer to the issue which you raised very early on in this hearing, before my testimony, we have not changed our view with respect to support of your bill. In fact, looking back we have put entrain a growth in aggregate credit and money supply that if maintained will, within a few years, reach the goals of your proposed bill.

Remember also that we are lowering at least tentatively at the moment our targets for money supply for M2, and since our effect on inflation is only through the credit markets, I think it is important to observe that we have succeeded really since the October 1987 stock market crash in maintaining a degree of restraint that has brought the 3-year moving average of M2 to the lowest level, I believe, in more than 3 decades, and in fact it probably goes back to the early 1950's in any prolonged sense.

So I would think that with a 5 percent or less than 5 percent M2 growth rate, annual rate, we are fairly rapidly approaching the level of monetary expansion which is consistent with long-term price stability, and if we don't fritter away the benefits of the last 2½ years—and I can assure you we surely do not intend to do that—then I see no reason to expect other than the achievement of general price stability as we define it over the next several years.

So that I see nothing in the actions we are taking in recent days which in any way alters our particular policy path, and I say, look at what we are doing. I mean, it is not an accident that money supply has come down. We have very purposefully, gradually and in a measured way endeavored to bring the growth rate down, and so far I think that we have been rather successful.

Chairman NEAL. I think you are moving in the right direction. I just want to say in a few words what I think you are saying here, and that is that you are on a course toward, I call it zero inflation, you call it price stability, and that you are not moving from that course and that that is positive for the economy, and I don't know, the way I read the drop in the stock market yesterday, it is that people have renewed fears of inflation, and I think you are trying to allay some of those fears.

Mr. GREENSPAN. Well, ultimately, Mr. Chairman, inflation is a monetary phenomena. We have brought the rate of growth in nonfinancial debt to the lowest level in two decades, and the monetary aggregates related to it, the lowest in three decades, and while I must tell you I am not actually overly enthusiastic about the price performance to date, as indicated in the charts which you have put around, I think that that is a lagging phenomenon.

And what it is important for us to do is to keep a very close eye on making certain that we keep the credit conditions moving towards a noninflationary environment because all history tells us that if we stick to that trend, we will achieve success.

Chairman NEAL. Thank you, Mr. Chairman.

My time has expired.

I would yield to Mr. Barnard at this time.

Mr. BARNARD. Mr. Chairman, you just said that you were lowering the M2 targets. Isn't that sort of reactive to what is actually happening, though?

I mean, it looks like to me—haven't we had an unusual change in M2 in the last 13 weeks? Is that unusual to what we have experienced?

Mr. GREENSPAN. Yes, it is, and in fact it is because it is unusual and in fact it has dipped below our calculated gradual downward trend.

We responded a couple of weeks ago to sort of give it a midcourse correction, so to speak. The slowdown in the 13-week average which you have got here is substantially the result of the resolutions of the S&Ls which, as you may recall, accelerated very substantially during the spring, and as I indicated in my prepared testimony, that had the effect of essentially reducing the growth rate in M2, but it was only part of the change.

In other words, it explained only a substantial but not all of the change, and it was the remainder of that change, so to speak, the implied tightening which we think is occurring currently in the banks and in the thrifts, it is in response to that that we thought that we needed to make the type of adjustment that we thought appropriate a couple weeks ago.

Mr. BARNARD. The adjustment you made was in lowering the Federal funds rate, right?

Mr. GREENSPAN. Well—yes. The effect of that is essentially to try to offset what we perceived as a widening in profit margins in the commercial bank commitments, which tended to create a higher loan level than had previously been existing, and the consequences of that was to create credit more than we had intended it to do, and as a result of that, so that our actions tend to offset that action as best we can judge.

Mr. BARNARD. So by lowering the targets of M2, does that mean that you are going to be lowering the upper range of M2 so that we will not have an unusual increase in M2 at some point in the near future?

Mr. GREENSPAN. That is the meaning of the targets. We have managed to stay over the last several years well within the range of our targets most of the time. Of course, it ended up reasonably well within the range over the period of time.

Mr. BARNARD. What significance today is M3?

Mr. GREENSPAN. Well, it is clearly of less significance than M2 largely because it has a major difference from M2's very significant amount of funding, purchases of funds which has created a degree of instability which has, in my judgment, made it a less useful tool than we have found M2, which we find even with all of its faults, to be over the long run an excellent measure of the state of our anti-inflationary posture.

Mr. BARNARD. I agree. I think that M3 at some point in time was significant, but I think today in what our initiatives should be that M2 seems to be the best guide to determine where we are going.

Mr. Chairman, the Federal Reserve Bank of St. Louis publishes something called the Monetary Trends, and one of the tables published is that for adjusted reserves, which is the adjusted monetary base less currency held by the public. Since February 1987, there has either been a decline in real or actual terms in this number.

I am curious if you attach any importance to this. I am curious, as it is undoubtedly true that reserve requirements for banks have been increasing over this same period of time.

Mr. GREENSPAN. Well, remember, Congressman, that the reserve balances to a very substantial extent in recent years reflect the holdings of demand deposits, and the importance of the reserve balance slowing down is a mirrored reflection in the slowing down in the growth of demand deposits, and as best we can judge from the various surveys which we have taken, there is a structural shift away from demand deposits towards fees.

That is, instead of requiring compensating balances which would be the large, fairly substantial chunk of demand deposits, banks have increasingly gone to direct fees and have eliminated to an increasing extent the requirement for compensating balances.

The consequences of that has been to slow the growth in demand deposits and therefore significantly slow the growth rate in the monetary—rather, in the reserve base as well.

Mr. BARNARD. How is that going to affect Fed decisions on monetary control because reserves—the Fed has always said that bank reserves was a very important ingredient or in the past it has been an important ingredient in controlling monetary supply.

How will that have any effect on Fed decisions?

Mr. GREENSPAN. Well, we have obviously incorporated what we observe in the markets and have adjusted our policy and procedures to accommodate what we perceive as the changes which are not material to affecting the financial system at the margin, so obviously it does affect us, we do react to it, but I think we make the appropriate adjustments. At least I have seen no evidence to suggest otherwise.

Mr. BARNARD. Mr. Chairman, it is generally agreed that the U.S. banks are having a difficult time attracting capital. Recent testimony before the Senate indicated that the U.S. commercial banks have almost $600 billion committed to high-risk lending activities, composed of LDC debt that has not yet been written off as well as highly leveraged transactions in commercial real estate loans. Over the last 4 years absolute charge-offs have totaled $75 billion.

Given your near-term view of the economy, can we sustain this level of write-offs, and where will the capital come from to replenish that which is expended? And also, what if there were a recession?

Mr. GREENSPAN. Well, first, Mr. Barnard, I mean clearly we have seen very significant reserving by the commercial banks, and indeed the larger banks, where the major LDC commitments are, have very substantially increased their reserves, and as a consequence, obviously their primary capital has risen quite appreciably.

I testified before the Senate Banking Committee a couple of weeks ago and outlined our view that capital requirements should be gradually raised in time. And one of the reasons largely is the notion that we have come off this period of rather significant difficulties and clearly increased capital is a solution not only to loan portfolio and loan quality problems, but also raises some very substantial benefits with respect to the issue of deposit insurance, the threats to the safety net, and the types of subsidies which that safety net creates for the depository institutions.

So I should think and hope that we will continue to see accumulation of capital as we move to the 1992 standards required by the Basel agreement, and it strikes me that having gone through the 1980's, I would certainly trust that the 1990's, as they proceed, will show trends in capital ratios of our depository institutions which are up and up sufficiently to ameliorate the types of concerns which your question implies.

Mr. BARNARD. Thank you.

Chairman NEAL. Mr. Bunning.

Mr. BUNNING. Thank you.

Mr. Greenspan, you mentioned history in responding to one of my colleague's questions. I would like to ask you kind of a history question as far as budget summitry is concerned.

Do you have an opinion that if a tax increase is included in any type of budget summitry agreement that it will actually reduce the deficit?

Mr. GREENSPAN. It would, Congressman, if as the Members of the budget summit apparently are committed to enact or make recommendations of means of enforcement.

In other words, I think the question of merely putting a budget forecast or asset of budget intentions out from a summit is recognized as not sufficient by those who are engaged in this activity, and they recognize that in order to capture market's response that some budget process structural changes that will cement or create credibility for the long-term budget agreement must be part of the package.

Mr. BUNNING. Can I go back to 1982 when TEFRA was passed, when there was a budget agreement that for every tax dollar that was increased in that increase that was passed, that there would be $3 of spending reductions, and of course the dollar of tax increase was passed, and we are still waiting presently to get one cent of those spending reductions.

In other words, that type of an agreement would not be one that you would be in favor of.

Mr. GREENSPAN. Well, whether I would be in favor or not I don't think is relevant. I think what is relevant——

Mr. BUNNING. It is relevant in this committee room.

Mr. GREENSPAN. No, I think what is relevant is whether the markets would react favorably to an agreement which didn't have some form of enforcement mechanism in it. My judgment is that the market would not.

Mr. BUNNING. It would not. Let me refer to your prior statement about the credit crunch. You said you didn't feel that there was a credit crunch of sorts in our economy presently.

Mr. GREENSPAN. Yes. I must admit it is a semantic issue and there are those who are sitting out there with great difficulty obtaining financing who would find the nicety of my language rather inappropriate, but in a technical sense credit crunch is really more applicable to what happened when in years past, we used to have ceilings on depository interest rates from Reg. Q, for example, and ran into massive disintermediation with immediate impact on the economy.

That is not what we are having today, and I think it is better described in terms as I put it as a tightening in the market as a result of depository institutions in an endeavor to appreciate their capital position pulling back more than would be involved in the *normal interrelationship between money market conditions and* commercial bank activities.

Mr. BUNNING. But isn't that a direct effect of the scrutiny of the regulators or the people that are out there overseeing the banks, the thrifts and other lending institutions?

Mr. GREENSPAN. It is very difficult to disentangle some of the motives. I think there are certain things which have got to be evident.

As I have said to this committee previously, the fact that there are a number of banks that have gone through a period of what is clearly in retrospect lax lending standards, it is virtually inevitable unless human nature has been repealed for them to be pulling back and be cautious.

Similarly, the examiners who were involved in that same process and in retrospect have had to have had the same reaction are invariably more cautious. Now, I am saying that that is not necessarily bad. Most of that, in fact in most cases, I think it is good, not bad.

The one issue which I raise is that I think in recent weeks the evidence suggests that we tilted, that the degree of tightening has gone perhaps a little bit more towards the undesirable than it had been, and I would certainly not say as far as I can judge talking with the Comptroller of the Currency, with the head of the FDIC, with my colleagues at the Fed, I see no evidence of any policy stance on the regulators' part to tighten up in a manner which creates the phenomenon we are looking at.

I think it is largely a response to the lax standards that existed, and to me I would not want to say that I have any really firm evidence which suggests that other than the normal psychological reaction that every human being would have, whether he is a banker or an examiner, I don't see anything which suggests to me that there is any program or certainly no policy which would endeavor to create what other people have called crunch.

Mr. BUNNING. Well, my time has almost expired, but I disagree because in dealing with those that have legitimate borrowing needs and that have been very successful businessmen, they are running into a brick wall on a daily basis trying to go out and borrow money to finance legitimate enterprises in this economy.

Mr. GREENSPAN. No. As a result of the regulants?

Mr. BUNNING. As a result of those overseeing banks and regulators and those banks reacting to those people who have come in.

Mr. GREENSPAN. I don't disagree with some of the conclusions you are reaching with respect to what some customers of banks are having. I think the cause of the problem, however, is what more complex than really the regulators putting pressure on the banks.

I think that their own capital positions and their own awareness of the best—of the actions required for purposes of maintaining safety and soundness has induced those actions wholly independently of what the examiners have done.

In fact, I would be inclined to say that the vast majority of the actions are initiated, in my judgment, appropriately by the commercial banks themselves independent and actions taken by the examiners.

Chairman NEAL. Mr. Hoagland.

Mr. HOAGLAND. Well, it is certainly a pleasure, Mr. Chairman, to have you before the committee again today.

I would like to join the chairman and my colleagues on welcoming you and for congratulating you on your steady hand and for the fine job you have done.

In order to help us read your crystal ball a little bit more clearly, I would like to ask you a question about the importance of the various variables to you and the decision making of you and your colleagues. One can construct multiple scenarios for the U.S. economy using different combinations of the kind of variables you have discussed today.

Most importantly, inflation rate and economic growth rate: What combinations of real growth and inflation are likely to lead to easing, steady or tightening monetary policy? For example, would you ease if real GNP growth slowed to under 1 percent as long as inflation were under 5 percent? Conversely, if inflation fell in the 3.5 to 4 percent range, would you be willing to ease even if the GNP growth rate were around 2 percent? In other words, what are the critical thresholds for your priority variables?

Mr. GREENSPAN. Well, the problems are I think requiring far more detail to evidence than just the hypotheticals which you suggested.

I would also want to mention that there are slightly different priorities amongst members of the FOMC, but I would say in general we have the basic view that there is no tradeoff, in a sense, between inflation and real growth. It is not sort of how does one balance those things, because I think that we are all pretty much committed, as I have indicated here numerous times in the past, to the proposition that a necessary condition for sustaining long-term growth is a noninflationary environment, and that in fact the quickest way to induce a recession, if one were really trying to do that, would be allow inflation to accelerate because it would surely undercut the economy very rapidly, and the instabilities that would occur as a consequence of that would create the type of economic contraction which would be very difficult to deal with.

I don't want to respond to your question in the detail that you give it to me not only because I think they are hypothetical issues, but I do think we don't have a simple rule which I could infer by polling the FOMC in a manner which would be responsive to your question.

Mr. HOAGLAND. But it sounds from your answer as if the most equal of all of the variables is inflation and that what the inflation rate is is the first variable that you look to. Is that fair?

Mr. GREENSPAN. Well, in an odd way we really look at credit conditions first because that is an earlier version of the inflationary process. Often when we see the effects in the price levels, the published price levels, that is an historical fact, and we may look at a period in which the published inflation rates are rather low for a protracted period.

But if we are in the process of rapidly expanding credit in this country and the money supply is moving at a pace which is inconsistent with the recently historical level of prices, what history tells us is that it is just a matter of time before inflation published statistics begin to rise to in many respects the elements of the published growth rates in GNP.

And the inflation rates are history. They tell us where we have been, but of necessity monetary policy must be forward looking, whether we like it or not, because if we tend to react to the data of the past, we will whip-saw the credit markets inevitably, and it is that process which we try as best we can, and we recognize that it is not easy.

We try to maintain a degree of stability consistent with long-term price stability on the grounds that that is the best way to get long-term stable economic growth, stable exchange rates, stable financial elements of all types, and it is the type of economy which is the most efficient and is most likely to have the highest degree of productivity growth.

Mr. HOAGLAND. Let me ask you a question on another subject, Mr. Chairman.

There is concern in business and economic forecasting circles about the quality of economic statistics prepared by the Government which are used for planning in the economy.

Revisions are often substantial and cause reasonable men to radically alter their assumptions about the future.

What statistics do you feel are most timely and accurate for capturing how the overall economy is performing at the margin; and if you could see only three numbers each week, which would they be?

Mr. GREENSPAN. Mr. Hoagland, I would suspect that I would choose three, and then three weeks later, I would decide that I needed a fourth.

At any particular time, there are only a few very important variables which you look at.

The trouble is that that continues to change, and the reason it changes is that at the margin where the economy is changing and where the forces of strength and weakness are continually altering, and so what you do is you find yourself continuously shifting what you are watching and what you are looking at, and as a consequence, while it is true there are only relatively few key indicators at any time, I think you will find that over a year's time, that what those particular key indicators were have probably changed three or four times.

Mr. HOAGLAND. Is there anything the United States should do, Mr. Chairman, to improve the quality of our economic statistic reporting? Should we sacrifice timeliness, for instance, for more accuracy, as some analysts have suggested?

Mr. GREENSPAN. That is a very difficult decision. I think it really gets to the question of how we use the numbers and how we adjust in our own minds what we know to be the degree of inaccuracy.

I think it varies, frankly, with individual analysts. I myself prefer early data even though it is to a large extent inaccurate in an exact sense because I think the order of magnitude of what is happening can usually be picked up by advanced data even if they are substantially revised.

I find that even after the revision your initial judgment as to what it signifies does not materially change, although in the statistical sense it looks like a major revision.

It is very important, for example, to know whether a figure is *going up or going down.*

It is far more important than how much it is going up or how much it is going down, and it is that type of growing judgment which is crucial to policymaking which require that we have timeliness even at the expense, if necessary, of significant subsequent revisions.

Mr. HOAGLAND. My time is up, Mr. Chairman.

Thank you very much for yours today.

Chairman NEAL. Mr. Ridge.

Mr. RIDGE. Thank you.

Good morning, Mr. Chairman.

I want to just follow up very briefly on some of the observations made by my colleague, Mr. Bunning, with regard to your assessment of the tightening of credit.

In discussing this matter with many financial leaders in Pennsylvania, there is a sense, at least in my mind, that there are a variety of factors that have been involved in what appears to be a voluntary—somewhat of a voluntary restriction of credit.

There is a whole psychology that follows after FIRREA. There is a psychology of the auditors coming in and taking a look at the books and assessing loans more critically than they have done before.

There is a move to get to the 1992 capital standards and we want them to continue to move in that direction.

I think there is a recognition that maybe they were a little lax in the eighties and they do have to tighten.

Is there anything that you have seen that would suggest that all of these have resulted in an overreaction or do you see that this restriction of credit, and I think it is out there, has nothing to do with its availability?

I mean, there is money to be lent. It just seems to many of us that the institutions are more reluctant to do so.

Is there any concern that you have that there has been an overreaction in this regard?

Mr. GREENSPAN. Up until fairly recently, there wasn't, but as I have indicated in my prepared testimony, I think we may have gone over the line on that, and I do think from the evidence which seems to be accumulating of late that the answer to your question is partly, yes.

Mr. RIDGE. What initiatives, what countermeasures, what do we do to get it back into balance?

Mr. GREENSPAN. Well, I think the first thing we chose to do was to see whether we could offset the negative effects in the money markets that occur as a consequence of that pulling back by easing slightly, as we did a short while ago, which is an offsetting action for purposes of trying to at least offset the credit stringency implications of going into too far.

Aside from that, there is not very much that one can do because what you are dealing with is human nature and human psychology, and you have to ask yourself if you hear a commercial banker or a thrift executive sitting in today's environment after what has occurred, would you be more inclined to be cautious than otherwise? The answer to that has invariably got to be yes.

Now, short of confronting that problem, there is not very much we can do except to try to create an environment in which the economy is in a healthy state, but the customers of the depository institutions are clearly creditworthy and have sensible projects because it is only a matter of time before the trauma of the eighties will wear off, and the reason that will wear off is that if there is an overreaction on the part, say, of a commercial banker who is pulling back more than he really should, he is going to find that one of his competitors is going to move in there and take over that business.

The balancing of risks is what banking is all about, and if you overdo it, you will go belly up, but if you are too restrictive, you will be out of business as well.

Mr. RIDGE. Mr. Chairman, I want to shift gears just a little bit.

If we can do something significant, you call it credible and enforceable in terms of reducing our deficit, in reducing the governmental component in the aggregate economy, then clearly we want to stimulate private consumption, private investment, and net exports.

Exports have been an increasingly significant factor, I think, in economic growth, particular over the past 2 or 3 years.

Would you agree that the continued improvement in our Nation's ability to export goods and services is a necessary component of the transition from a reduced government component to the private sector component, and would you have any specific recommendations to accelerate export promotion?

Mr. GREENSPAN. Well, Congressman, I wouldn't say it is a necessary condition, but there is no doubt it is a very important element in that transition, and indeed, one of the reasons why the economy, which is rather sluggish, obviously, currently is still growing is the export order pattern.

In other words, if we look at the structure of manufacturing orders, it is fairly clear that the share of export orders in the total continues to rise and that it is supporting what is a very sluggish order pattern, and it continues to be a factor which I think continues to move us forward.

I am not sure we have to go through export promotion in the Government-sponsored sense, but I do think that we have observed and increasing propensity to look at foreign markets on the part of U.S. manufacturers who have clearly become more competitive in recent years and capable of dealing with those markets in an increasingly impressive way.

Would I like to see it expand much further? The answer is most certainly yes, and I think if we are able to significantly improve or continue to improve our export competitiveness, I think it will be a very important element in economic growth in this country.

Mr. RIDGE. Thank you, Mr. Chairman.

Chairman NEAL. Mr. Neal.

Mr. NEAL OF MASSACHUSETTS. Thank you, Mr. Chairman.

Mr. Greenspan, you speak appropriately to the credit crunch questions that I had raised earlier, and I think as a follow up to what Mr. Bunning and to what Mr. Ridge have suggested this morning, that in New England there is a perceived credit crunch, and it seems to me that the small business person is the individual who is really getting hurt at the moment.

I think that you can see that in an overreaction from the banking community which has contributed to a significant downturn in the New England economy.

Mr. Butterfield's piece on the front of The New York Times, I think, spoke eloquently to that issue.

Maybe you can give us a synopsis on what you think has gone wrong with the New England economy.

Mr. GREENSPAN. Well, Mr. Neal, I think that it is important to look at different regions in the country.

There is no question that New England is under significant stringency with respect to its overall economy from what was clearly a booming economy for a number of years, the rate of growth first slipped very dramatically and now it is clearly in some difficulty.

We are aware of that and have been monitoring it in some considerable detail.

The hot line up in Boston, I think, has been useful. We have to recognize that a very substantial part of the contraction in in credit availability is reflective of the weakness in the economy itself.

It is a decline in demand, and so what we are observing in the issue of softness is to a large extent the economic structure of New England.

Nonetheless, I do think it is important to emphasize that the underlying structure of New England remains healthy.

I mean, it is competitive, it is a strong competitive environment, and I think that this is an adjustment process which will take a while to get through.

It is clearly—it is very difficult, and I think a number of people are in trouble, but it is nothing, as I see, that is fundamental to the structure of the New England economy that strikes me as suggesting that this is other than a temporary phenomenon.

Mr. NEAL OF MASSACHUSETTS. OK.

Thank you, Mr. Chairman.

Chairman NEAL. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

One question about the budget, Mr. Chairman.

The Fed has taken a risk, kind of an invitation to Congress in just slightly lowering interest rates in anticipation that Congress might have a successful budget conference with the executive branch.

Mr. GREENSPAN. Let me just interrupt on that. That is not the reason for our action, Mr. Leach.

I mean, the reason basically is we are endeavoring to offset what we perceive of as independent tightening in the markets by the depository institutions, and we in no way even remotely contemplated that action as being in any way associated with——

Mr. LEACH. I stand corrected.

I think it is always presumptuous to apply motives to someone else.

You are the only one who knows your own motives. Your assertions must obviously be correct, so I apologize. But can you tell us what happens if there is no budget agreement between the leadership of Congress and the executive branch?

Would you say interest rates are likely to go up? Would you say there will be a shaking of confidence in the economy?

Can you tell us what your judgment is on that?

Mr. GREENSPAN. Mr. Leach, I wish I could give you an exact scenario of what would happen. I can't because I frankly don't know, but it is not fraught with benevolent events.

Mr. LEACH. Just to flush this out a bit, nonbenevolence is an interesting thought, but it would be a danger to the economy, would you say?

Mr. GREENSPAN. I would say that we should not risk failure in this respect.

Mr. LEACH. Well, I would like to flush that further, but I think you would rather I didn't, so let me just move to a couple of comments you made earlier in response to questions, and to flog a horse that maybe I flog too often.

You notice that banks have moved on their own to reserve certain things unrelated to what regulators might have insisted upon, in effect a self-regulatory effort in commercial banking.

Let me just say that I don't take enormous solace in that fact, even though the Fed has helped instigate some leadership in this area. Let me just make four or five quick observations.

With some exceptions, most of the larger banks have not reserved their foreign loans to levels reflecting their secondary market values. They haven't reserved them to levels that outside observers like Moody's or the GAO have suggested would be appropriate.

Second, a portion of these loan loss reserves can be counted as part of tier-two capital.

Now maybe in an instance or two, like Morgan, this is appropriate, but the fact is for most banks that defies common sense.

Third, the lesson of the thrift debacle was that the only prudent curtailment of excessive growth is adequate capital ratios based, and here I would stress, on prudent accounting. One has to have an accurate way to measure capital ratios. If one doesn't have an appropriate reference, excessive growth can occur. I would like to just stress here for a second both in relationship to the thrift issues as well as the LDC issue that when you have different standards between similar kinds of institutions, you impel growth in the institutions with the weaker standards. That is what we had with the thrifts.

When you have different standards between States, you impel growth in the weaker regulated States. And when you have different standards between similar kinds of institutions, in this case between one kind of bank and another kind of bank, you impel growth in the weaker regulated banks.

As the fourth point, one of the lessons of the LDC misjudgment is, if anything, that bigness deserves tougher appraisal than smallness.

If you remember in the late seventies, every major bank testified that because of the breadth of their loan portfolios, because of sovereign guarantees, they were in a more prudential position to leverage capital than smaller institutions.

If you look at the economy growth has occurred in the small business sector, which relates to small banks rather than large ones. Furthermore, it is easier to attach 100 acres of Iowa farm land than Brazil. If anything, the case at a minimum is for comparable standards between big banks and small banks. I think quite rationally someone might argue as they look at the rationalization for big banks' existence, which has changed dramatically in the last decade, that big banks ought to have tougher capital standards than small ones because they are more dangerous entities to run. What we need is not just a Basel accord where we see the lowest common denominator for foreign standards applied, but maybe a Des Moines accord where we apply Iowa internal standards to commercial banking instead of foreign. If you did that, you would find the banking system propelled towards a little higher capital ratio, especially tier 1 capital, instead of what I think is going to become internally a race to have capital standards erode a bit from those banks which are more prudentially regulated in the domestic banking system, particularly banks in rural States. Whereas the larger banks may come under a little greater pressure to upgrade their capital position.

Can you give us a little more indication on the direction the Fed is going to take with regard to capital ratios?

Mr. GREENSPAN. Well, Mr. Leach, we are obviously looking at this whole question in some considerable detail, and indeed it is our increasing awareness that capital solves a lot of problems that has led us to the conclusion that it would be useful over time to have equity asset and capital asset ratios generally moving upward.

The risk-based standards which are embodied in the Basel accord do come to grips with some of the issues you raise, the Iowa standard versus the international standard, and I think we are all acutely aware that the mix of assets and liabilities and the collateral underlying them are clearly quite crucial to the issue of what capital requirements should be.

While we don't believe that the Basel accord at this particular point encompasses all of the risks that we ultimately would like to monitor, I mean, for example, interest rate risk is not there. It is a major advance in getting sensible standards.

Mr. LEACH. Well, I concur. I don't want to take more time, Mr. Chairman.

In fact, it is up, but if I could comment for 10 seconds. I think it is a step forward, but whether or not it is a sufficient step, one might have some questions based upon definition of reserves. If banks can self-define their levels of reserves, then they have the capacity to say that they meet a given, let's say 4 percent, tier 1 capital leveraging ratio. If that self-definition is less than every prudent outside observer thinks is honest accounting, then one of the interesting questions is whether you have accounting gimmickry.

Certainly not to the degree that it occurred in the thrift industry, but to the degree that warrants attention. I think it has to be considered the responsibility of the regulators to ensure consistent accounting practices. In that regard, everything begins with numbers. I just hope that first, there is concern on whether the Basel accords are only a great first step and not a final step.

Second, that the numbers or the accounting practices that go into the numbers are very important.

Mr. GREENSPAN. No, I would agree with that, Mr. Leach, and in fact, while it is certainly the case that each individual bank sets its own reserves and its own reserve standards, examiners do oversee what is being done and is part of the examination process.

I mean, there are reasons in certain instances. They may be incorrect, but it is not just arbitrary that in some cases reserves for particular LDC loans do not seem in any way close to the discounted value of some of those related assets in the secondary markets, and I think the reason on many respects is that the individual institution does not envisage itself as having loans that are short-term investments that will be rapidly turned over, but rather looks at their commitment in a particular geographical area or country as a permanent type and do not think it is appropriate to write down to the particular marginal market value of all of its assets to get an appropriate view of what the portfolio is actually worth in the same manner that individual bankers on domestic loans don't evaluate each individual loan to a long-term customer by market changes which could be the result of market interest rates or other things, but they look at it over a longer term time table.

Nonetheless, it is certainly required of and indeed examiners do look closely at the reasons why reserves are set as they are, and as you know in the ICERT process, there is actually mandated write-offs in certain instances.

Chairman NEAL. I want to recognize Mr. Schumer at this time.

I want to say we want to welcome several Members of the full Banking Committee who are not Members of this subcommittee. I don't know which Mr. Schumer this is. I think there must be three Mr. Schumers in the Congress. I don't think I have ever known anyone so hard working and active on so many committees.

Chuck, you are welcome. I recognize you.

Mr. SCHUMER. Thank you, Steve.

Thank you, Mr. Chairman.

Once again, your testimony is welcome. You are getting very, very good at the art of testifying before Congress, walking all those little tight ropes. I guess you can judge it by the number of people who rush out of the room after you have said something.

I take it that wasn't because they served a bad breakfast this morning.

Anyway, on the weakness of the economy, you said last week that were were a shade more—those are your words—in the direction of recession. My question relates to the fact that—about the depth of a recession, if it should occur.

Given the S&L crisis, problems in the banking industry, the greater leverage our companies have, that our corporations have, do we have to worry that if we were unfortunately to go into recession, that it would be a deeper and stronger recession than one we have known in a long time, particularly in financial services and led by financial services?

Let me start with that.

Mr. GREENSPAN. Mr. Schumer, that is very difficult to judge. I think we know several things. We know that in the past, specifically in the post-World War II period, recessions were to a large extent inventory recessions, and that in recent years, there has been unquestionably significant increasing management of inventories to the point while at the moment there are very modest areas of excess in general, there is not.

In addition, an increasing part of our inventories that we hold are imported goods rather than domestically produced goods, which means to the extent they are inventory directions, they are backed out of both imports and production.

I would say at the moment, even though we have a very sluggish economy—and it is really quite soft, as we have seen in the last 6 months or so—the inventory imbalances do not seem to have arisen, which suggests—as they often did in the past—the beginnings of a tilt over.

This suggests that if we are to have a recession, or if a recession takes place—and clearly we at the Federal Reserve are not seeking that, because we do not believe it serves any useful purpose—but there are markets out there—and there are—there is nothing out that I can imagine which has said we have somehow repealed the business cycle.

So in the event that we do have a recession, it is clearly going to be a somewhat different type. I am not sure that one can reasonably make judgments as to what the nature of it is, since we haven't really observed that sort of phenomenon in recent decades.

Mr. SCHUMER. Does it mean we should, perhaps, be a little more—given there is sort of the unknown out there, and given these other factors which do trouble me significantly, the weakness in the financial sector, the over-leveraging, all the effects of the eighties, should we be a little more careful than we otherwise would be in avoiding recession because of the potential unknown or the potential depth of it?

Mr. GREENSPAN. I am not sure how one does that.

In other words, as I indicated to you on many occasions and here earlier, I am not sure whether the solution—so far as monetary policy—to that problem is whether you tighten or whether you ease.

I think what we have done, which certainly is quite helpful, is we have brought the rate of growth in credit and money supply down quite significantly from its high points several years ago, and the best thing that we can do to insulate the economy from the excesses and the imbalances of the past is to try to create an environment in which what you have got is a less dramatic growth in credit, more caution, because having said—as I have said to your colleagues here—that the contraction of credit has been a problem for a lot of people.

A substantial part of that contraction in the rate of growth is healthy. In fact, I think it buttresses the financial system and alleviates some of the distortions that clearly exist and the types of problems which you find worrisome and so do I.

Mr. SCHUMER. You know, there is a lot of speculation that if we come to a budget agreement because of the squishiness of the economy, that we ought not to reduce the deficit by too much, and hence, perversely plunge the country into recession.

I guess we are in the same situation as you are. We don't know how much is enough, and so forth.

There has been speculation that I have heard from various people, various parties, we ought not to reduce the deficit whether by revenues, or cuts, by more than $50 billion even if that means we have to revise the Gramm-Rudman targets upward.

What is your view?

Is there a limit to how much we should cut?

Mr. GREENSPAN. There is a limit, Mr. Schumer.

Mr. SCHUMER. Is $50 billion an appropriate amount?

Mr. GREENSPAN. $50-to-60 billion, as best we can judge, is handleable. I think we have to be very careful, however, to allow our concerns to undercut our resolve to get this issue done, because it is a very tough process.

As I indicated earlier to Mr. Leach, I think that if we don't do this, there are problems out there. I can't forecast to you what the short-term problems are, but I certainly know what the long-term problems are.

They clearly are inadequate savings, inadequate investment, inadequate growth in productivity and living standards, and if we find reason after reason not to act, we will end up with the worst of all worlds in that respect.

Mr. SCHUMER. A question on credit, the credit crunch which you have talked about.

I am troubled as I study the banking industry in the way credit decisions are made, in the fact that it doesn't seem—and this is to an outside observer. I am not in the room when they are making these decisions.

But it doesn't seem the banks rely on the old fundamentals as much as they used to. Look at the numbers, say we will lend here, we won't lend there, we will lend here, we won't lend there.

Instead, there seems to be more of a—well, it is referred to as a herd instinct. I don't mean that unkindly. It is hard not to mean it unkindly.

Let me think of a better word. Sort of a trendiness in banking as opposed to looking at the fundamentals.

One of the things that hit home to me on this—and I want to relate it then to a specific question—when I read about the foibles of Donald Trump, I saw two of the smartest banks or groups, banks that were alleged to be the smartest banks around had given him large amounts of unsecured loans after others had given him lots of secured loans.

This was not recently, but before his trouble began.

Also related to this credit issue and how banks make credit decisions is the fact that I hear in my area, just like in Mr. Neal's, that small businesses—I had a small businessman in my district come to me the other day. It is a pretty significant business.

He showed me a statement. It said profits were as good as last year, prospects are very good, his bank just cut him off. Big New York bank.

While I certainly understand, say, in real estate there has been over-building and the banks are serving a very worthwhile function in cutting off credit, small business, it seems to me, these types of small businesses are in as good shape as they ever were.

They are getting credit cut-off, too.

My fundamental question that underlies all of this is are you—have banks changed? Has this new free world changed the way they make credit decisions?

Are they less able to make fundamental credit decisions?

Is there more trendiness in this area?

Is there anything that can be done about it?

Mr. GREENSPAN. Well, I think to the extent that there was, as you put it, trendiness in the mid-eighties, I think it is back to fundamentals now.

I think one of the things that we are seeing and one of the elements which I suspect of causing a lot of borrowers great difficulty is we are wrenching our way back to what is normal and in certain respects, as I indicated earlier, I think some have gone over the line.

There is more retrenchment than is probably desirable in the long-term interests of the particular depository institution.

The trouble with lending standards and lending is that it is not easy. It is a very difficult process to try to evaluate what the risks of a particular venture are and there is no way to avoid that because banking is an evaluation of risk.

I think that not only do the data and the hard numbers make a difference, but there has always been in banking the issue of the bankers' perception of the individual with whom he is dealing.

You know, these wonderful, historical anecdotes of banker X lending to a young, new entrepreneur strictly on the grounds of he thought the person very capable and was investing in the person, something great occurred as a consequence of that, that still happens.

I think appropriately so.

It is not a simple, numerical activity. Lending activity is partly art form, partly psychologist-related.

Mr. SCHUMER. My worry is there is more psychology and more art and less numerical fundamental mathematics, than there was 20 years ago.

Mr. GREENSPAN. No. I am not sure that is true. I think there may have been less somewhere between 20 years ago and now, but I think now we are OK.

Mr. SCHUMER. Thank you, Mr. Chairman.

Chairman NEAL. I would like to recognize Mr. Weiss at this time.

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

If I may, Mr. Chairman, and Chairman Greenspan, just follow up on one of the questions Mr. Schumer asked. Recognizing this fine line that you are constantly working between or around as to the dangers of inflation, the dangers of recession, and cognizant of the answer you gave about the long-term consequences of not bringing the deficit down, what do you say to these economists who argue that as a percentage of GNP, in fact, the deficit is no great shakes and that the efforts and the concern about the size of the deficit has been over-stated and, in fact, made by trying to bring it down, even the $50 or $60 billion you are talking about, we may, in fact, be moving toward a recession much more quickly than otherwise would be the case?

Mr. GREENSPAN. First, Mr. Weiss, I think that the issue of the size of the deficit relative to GNP is something which must always be related to the savings rate within the economy.

Were our savings rate, let's say, higher than what it currently is, I think we would have little difficulty with the deficit.

The reason we have problems, the reason we find we have problems in financing it, the reason we are concerned about it is our savings rate, domestic savings rate, is too low to sustain the level of deficit that we have.

We do not have the lowest—the highest deficit as a percent of GNP of the major industrial countries. On the contrary, we are somewhere in the middle to the lower end. But our savings rate is substantially below the average and the consequence of that means that that deficit is—has a first claim on domestic savings and what is left is clearly inadequate to create enough domestic investment to maintain economic growth or at least economic growth to which—to levels which are desirable.

I don't think—I am aware of the people who argue it is an accounting problem and that we are over-emphasizing this issue. I don't want to get into the details of the elements of that argument, merely just to say I do not agree with it.

I think the deficit is a real problem, that it is—has a corrosive effect on long-term economic growth in this country; and that while unquestionably if we reduce the deficit, we do remove purchasing power from the economy and other things equal, clearly that would create additional strain.

But to the extent that you lower the deficit and it is, in fact, really reducing purchasing power, not just a paper transaction, it almost surely would also be reducing long-term interest rates which would galvanize demand in other areas of the economy, and as a consequence of that, it is not clear to what extent the reduction in the deficit is a net reduction in aggregate demand.

I am reasonably certain that a large deficit reduction net on balance will be some reduction in demand, and to that extent, I think the long-term financial markets would respond and we would probably be responding to the long-term financial markets to try to maintain continued stability in the economy.

Mr. WEISS. I guess implicit in your response also is the expectation that if, in fact, the path that you suggest and that was suggested for reducing the deficit just right will, in fact, encourage increased savings, but I must tell you—and I have not looked at the numbers, and I don't know the answer, and I ask it of you: it seems to me for as long as I have been in this Congress—about 14 years—there have been expressions of concern about the fact that we as a society simply do not save and that we compare ourselves to the Japanese, with the Germans and we don't save.

Now, what is your real world expectation that, in fact, that is going to turn around and why do you think that it is going to turn around?

Mr. GREENSPAN. Mr. Weiss, I think you are raising the issue, which bedevils economists in this country more than any other issue of considerable importance.

I would consider that our inadequate savings is the number one long-term problem that this economy has. While we have engaged upon a number of different tax-related initiatives to try to improve it, it is not clear that they have been very successful.

Some have been partly, but there has not been a major change.

That is the reason why I have argued that if you cannot increase privatization appreciably, that at least we should reduce the drain on the privatization which the Government deficit creates. Even better, to run a surplus in the Federal Government accounts so that rather than subtracting from domestic savings, one is adding to it and creating a larger pool of savings from which domestic investment can flow with the consequent improvements in productivity and standards of living.

Mr. WEISS. Thank you.

Thank you very much, Mr. Chairman.

Chairman NEAL. Mr. Chairman, I want to change subjects for a moment here. As you know, since our foreign exchange system intervention is sterilized, that is to say its impact on aggregates is offset by open market interventions so it has no impact on monetary policy, why should the Fed be conducting such intervention at all?

That is the first part of the question. I would like to go ahead and finish and add something to it before you respond.

The point is why not let the Treasury do all the intervening out of its Exchange Stabilization Fund? I mean adjust out of the Exchange Stabilization Fund's own funds not using funds obtained from the Federal Reserve through the practice of warehousing, as they do now.

The Treasury would then have to come to the Congress to get more funds for the Exchange Stabilization Fund if it wants to go beyond the amount already in that fund.

Since intervention is a risky undertaking with potential for losses to the taxpayer and since its effectiveness is very much in question—in fact, I don't think it is effective at all—shouldn't the Treasury be required to come to the Congress and justify its request to gamble on the foreign exchange markets with additional taxpayers' money?

Through its current warehousing arrangements with the Fed, the Treasury has access to funds without any accountability to the Congress and to the American taxpayer. So you can see the question is in several parts.

I would like to yield to you now for a response.

Mr. GREENSPAN. Well, Mr. Chairman, I think you are raising issues which are very thoroughly debated by economists, international economists, domestic economists, and I think at this particular stage, the consensus, if one can conceivably draw such a notion, is that the evidence is that intervention solely on its own can at best only stabilize short term situations and does not have a permanent effect on exchange rates.

There are, nonetheless, those—and I must admit many of my colleagues—who believe that it is worthwhile at the margin to do intervention and thereby stabilize, to a certain extent, the normal volatilities that do exist in exchange rates.

They do not, and I do not perceive it as any sort of speculation. It is an endeavor to add an element of stability to the system.

I think that there is a growing awareness that it is far better for central banks to try to move towards a general non-inflationary environment so that the long-term stability of exchange rates is assured and then allow that process to be the major factor in stabilizing rates.

I think that issue is evolving, but it is still a debatable question as to whether it is strongly useful, marginally useful, or not useful at all.

I think at this particular stage, the majority, if one could put it that way, is that intervention is marginally useful.

On the issue of restricting the Treasury from borrowing until they came back, if they needed additional funds to increase their balances, I would recommend against that on the grounds that to the extent that the activity is pursued at all, it cannot await the process of congressional action to essentially specify more funds.

My judgment basically is that the system is working reasonably well.

I think that the Federal Reserve should be involved with the Treasury because I think the combination of our constant activities with respect to those actions, in my judgment, have been helpful rather than a hindrance in the sense that we bring to bear sources of information not only that those which the Treasury has in its international dealings but our information which is collateral information and even though Treasury takes the lead in the underlying policy with respect to the process, we at the Fed are strongly influential on what actions are taken, when they are taken, and the processes that are involved such as warehousing or the size of the Reserve balances that we build up.

So I would suggest to you that many of the issues that you raise are issues which are in current debate, and I think significant debate, but at the moment, I would recommend against any substantive change in the process because my impression is that it will evolve in a way which will reflect the underlying market forces which we are obviously endeavoring to affect.

Chairman NEAL. What you are saying is the intervention is only marginally useful, which I agree with. I guess the argument there would be whether it ought to be done at all in the real world.

You are moving toward that. I couldn't agree with you more what we ought to do in terms of coordination is each run its own economy in a sensible way and that would be the best possible coordination.

And I am delighted, I must tell you, the Treasury is calling on you, your economists, and so on, for your wisdom in dealing in this area. My concern goes a bit beyond that, however.

As I understand it, you have something like $26 billion now of your——

Mr. GREENSPAN. Talking about the Federal Reserve System?

Chairman NEAL. The Federal Reserve. I didn't mean your pocket change. I know you could do it.

As I understand, you have something like $26 billion worth of Federal Reserve money at risk here. The degree of risk is probably not great. Anyway, it is engaged in this kind of activity which we have both said is of marginal usefulness.

It is being done at the request of the Treasury. The Treasury has its own taxpayers money at risk. At least there are some—ultimately, there is a little accountability there. There is no accountability here at all.

As I say, it is a marginal utility. I personally don't think it should be done. I know the leaders of governments love to engage in this grand foreign policy strategy and so on and put the taxpayers' money at risk doing it.

As I say, I think we ought to put as many limits on that as we can.

Beyond that, we have the situation where they are telling you what to do. They are not subject to any oversight, any accountability in this area.

You have to do it. I just must say I think it is a mistake. I don't think you fully commented on this aspect of it. You commented on several important points.

Mr. GREENSPAN. Mr. Chairman, let me say that it is not an issue of the Treasury really giving us instructions, we being their fiscal agent.

In this regard, the actions to engage in foreign exchange trading are implemented at the Federal Reserve Bank of New York and the instructions that occur are the result of discussions which exist between officers of the Treasury and officers of the Federal Reserve.

When there are major policy issues that come up with respect to significant changes, the Treasury Secretary and myself discuss them at length. I do not recall an instance in which we were in a sense, instructed to do something without our getting one to comment on it and actually to alter its nature. So it is a consultative process.

It is a partnership. I think it is working reasonably well. I do acknowledge the fact that there are elements of risk involved, but the odds actually favor us in the market, so that what occurs usually is that there is a net profit in the particular process.

But even granting that, I think that it is important that we make available as we do the full detail of our activities periodically, and I think that we endeavor to make certain that through these reports that Congress and the public know in detail what it is we are doing.

Chairman NEAL. Mr. Chairman, my time is expiring. I want to point out, as you probably know, the chairman of the full committee has noticed this activity and he intends a set of hearings on it.

I know I will be trying to attend those hearings, as well. I hope you all are aware of that and will help us again with your wisdom.

I don't think the public is going to be too happy about the vast amounts of money involved. I think these hearings will attract more public attention to these activities.

One of the worries that I have along these lines is that it might lead to some other—some remedies that might be not beneficial to the Fed's continuing conduct of its most important responsibilities.

One of the recommendations that the hearings will be held on is a scheme to get in and audit the foreign exchange operations which would lead to an audit of the open market operations and so on, which I personally think would be unfortunate. I will try to ward that off.

Again, this is another aspect of it. I hope you are fully aware of it.

Thank you for your comments.

Mr. BARNARD. Shifting gears again, Mr. Chairman, throughout the discussion of the savings and loan and bank failures throughout the eighties, there has been a criticism of the quality of the bank regulatory supervisory agencies. Can you give us any encouragement that this has improved?

Mr. GREENSPAN. You mean whether the supervisory and examination process has improved?

Mr. BARNARD. [presiding.] Yes.

Mr. GREENSPAN. I would say most certainly.

Mr. BARNARD. What changes have taken place to cause that improvement?

Mr. GREENSPAN. I would say the extraordinarily large amount of soured loans which has not only got the attention of the depository institution thrift, but also those involved in examination and oversight. So I am saying it is, in a sense, almost an automatic response when one is confronted with activities which didn't work and creates problems.

Mr. BARNARD. Are you saying it was done internally within the bank more so than it was done through the supervisory agencies?

Mr. GREENSPAN. You mean the changes?

Mr. BARNARD. Yes.

Mr. GREENSPAN. If we are talking about commercial banks, I would say yes. That is, commercial banks—the commercial bank in today's environment confronted with the increasing loan losses it has had in recent years has very carefully reevaluated its loan policies and its processes all for the good, in my view.

Mr. BARNARD. When we go back and see some of the reasons for the tremendous failures in banks, do you see there is any place in the future for credit allocation?

And I mean particularly a lot of the banks funded these LBOs and now they are having to either—they are having to extend the loans, they are having to re-finance the interest on the loans. Does that cause you some concern that we might need to go to allocation of credit?

Mr. GREENSPAN. I would be most resistant to do that, because I think it would be extraordinarily inefficient and it presupposes that examiners or regulators have greater insight into the risk balance in particular loans than commercial bankers.

I would far prefer to allow those judgments of allocation to be made by bankers rather than by examiners who, I do not think, have the skills.

Mr. BARNARD. Congress has taken note as to whether or not that is the best use of bank credit. Do you think it is Congress' province to give consideration as to where banks should be making their loans?

Mr. GREENSPAN. Obviously, Congress can do what it chooses. I would just merely say in my judgment it would be ill-advised.

Mr. BARNARD. Mr. Chairman, as a member of the RTC Oversight Board, what is your reaction to the fact that by December, we may be having as many as 900 savings and loans in conservatorship? Being run by the RTC?

Mr. GREENSPAN. My reaction is that that number had better come down sooner rather than later because the extent to which we in government have to run these institutions is not in the best interests either of the institution's financial system or the economy as a whole.

So I should certainly hope that the RTC, whose basic job is to essentially resolve the troubled institutions, do so sooner rather than later.

Mr. BARNARD. Are you pleased with the pace of resolution of these problems?

Mr. GREENSPAN. I am at the moment, Mr. Chairman.

Mr. BARNARD. You do not think we need any particular changes in FIRREA to accomplish a more speedy or more efficient resolving of savings and loans?

Mr. GREENSPAN. I don't think so at the moment. I think we were slow getting up to the starting line, but I think there has been clear acceleration at this stage.

So far as the speed and pace of resolution, I don't think I envisage the need for any particular legislative initiatives.

Mr. BARNARD. Are you comfortable—not comfortable, but are you in agreement with the current estimates of the additional cost to the RTC which is now up to around $147 billion?

Mr. GREENSPAN. I believe the estimate that the Secretary of the Treasury testified to was a range of between 90 and $130 billion.

Now, that is the cost of the losses since FIRREA. It does not include interest.

That is the reason why it is a smaller number than some have employed, but it will take a while to get firm estimates and exact estimates will not be known until the assets are sold in the market rather than merely allowing them to accumulate in receiverships and be priced for purposes of this loss evaluation in a rather proximate way.

So we will not really know what the full cost is, but I have seen the estimates that are being made and the 90-to-130 billion dollar range is roughly in the appropriate area.

Mr. BARNARD. Do you think that we ought to include this cost on budget?

Mr. GREENSPAN. I think the crucial question is do we—is the financing of the RTC—does it have similar effects on the economy as regular Treasury financing? And the answer is not quite. There is a big difference between whether or not you raise money in the capital markets and create financial transactions or whether you raise money in the financial markets to fund military expenditures, say. The first one does not affect savings and investment, the second one does.

It is probably likely—as I have testified here before—that the overall rate of interest is probably not materially affected by borrowings to fund the RTC, although the yield expressed between Government issues and private issues probably narrows in the sense that the U.S. Government rates move higher relative to the private rates.

But the average interest rate is probably not significantly altered. That is not the case in borrowing for goods and services, so to speak.

So in this context, I would be inclined to think of the RTC borrowing as off-budget and especially the case when we consider the working capital requirements of the RTC if for no other reason than by the way we construct that borrowing.

Of necessity, every cent is repaid.

So we have a period when Treasury borrowings go up as the working capital goes up, then it goes down when it is liquidated. I am concerned not about the going up as much as I am when it is going down, and it makes the deficit appear less than it really is.

So in that sense, I would be far more comfortable if the RTC borrowing requirements were kept separate, whether you call it off-budget or not. That is an accounting notion, but clearly one should separate that in evaluating both the elements involved in the budget summit and in the subsequent reporting of our progress towards a balanced budget.

Mr. BARNARD. Mr. Hoagland.

Mr. HOAGLAND. I would like to ask you a question, if I might, Mr. Chairman, about service sector price inflation.

On page 3 of your statement, you notice that it has shown little sign of abating. As I understand it, senior administration officials talking about the desirability of lower interest rates have on several recent occasions suggested that monetary policy is not an effective tool for combatting inflation in the service sector.

What is your view as to the merit of those arguments?

Mr. GREENSPAN. I disagree with that point of view. I think the way in which monetary policy affects service prices is usually through the wage component, and to the extent that monetary policy slows unit costs in general, but very specifically, the growth in unit labor costs, then it will feed over into service prices.

It is certainly the case that goods prices have been far—have shown far less increase than service prices in large part because there is an additional element involved in goods prices, namely, the competition from abroad and the significant increase in import competition which has tended to lower the general rate of increase in goods prices in a way it works through, in part at least, improving productivity or inducing improved productivity in the United States where that clearly is of only marginal assistance with respect to service prices.

But since there is a single labor market, the competition that exists between service prices, or the service sector, and the goods sector of the economy, inevitably induces a spill-over from the restraining inflationary effects in goods onto services, as well as the basic direct effect of monetary policy on wage inflation and, hence, prices.

So, overall, while it may appear to be slower working or have certain different characteristics from goods pricing, service prices do respond to monetary policy, and indeed, our view is that we look at the aggregate price level as the crucial element involved in the economy because it is the aggregate price level which basically affects risk premiums in financial markets.

It is the aggregate price level which creates the degree of instability or lack there of in the investment markets, I mean capital investment. And that we should not be separating for purposes of monetary policy the endeavor to suppress inflationary pressures in the goods markets as distinct from the service markets.

Mr. HOAGLAND. Let me, if I might, ask you a question about international capital flows. One risk of the United States becoming a large debtor nation in our global economy is that we may lose control of our own monetary policy because of international capital flows.

If the next 12 months' inflation is stable at 4 percent, but the economy weakens further—and let's say you and your colleagues decide to ease—isn't it possible that any addition to the Reserves would be offset or could be offset by capital flowing out of the United States because interest rates are higher elsewhere and the dollar is perceived weak?

I wonder what your policy alternatives are in that scenario?

Mr. GREENSPAN. Well, I don't think there is any question that as the global isolation of monetary policy increases., that we at the Federal Reserve and our colleagues in the other central banks find that we must increasingly react to international forces and to that extent there is an element of also certain control, but it is not a major issue. It is actually quite minor. It nonetheless does underscore the need for central bankers to coordinate as we do.

We meet periodically to exchange views on policies and try to, where appropriate, endeavor to coordinate.

But while there are problems—and I think you correctly identify the nature of where the problems are coming from—I would scarcely argue that it undercuts the Federal Reserve's ability to do the job they are required to do.

Mr. HOAGLAND. Have there been any periods since you have been Chairman where your moves have been offset or partially offset by international capital flows and if there were any such periods, is there any specific action you took about that?

Mr. GREENSPAN. I don't think so. Trouble with respect to knowledge of capital flows is late. We don't get the data as rapidly in full detail as one would like to make the types of judgment you suggest, Mr. Hoagland.

But I think that our knowledge of those flows in a very general way is adequate for the purposes of monetary policy domestically.

Mr. HOAGLAND. Thank you, Mr. Chairman.

Chairman NEAL. [presiding.] Mr. McCollum.

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

I am sorry I couldn't have been here for all the questioning this morning. I had a markup in another committee.

I know you are asked inevitably questions. I heard you were again this morning about the budget, about deficits, questions, of course, that should be asked here about the M's, M1, M2, M3 and all the factors that go into monetary policy.

I guess I have a bottom line question after all is said and done.

It isn't one to ask you what you are going to do, which I don't think you should be answering and you won't in here.

But every time that we get into these discussions, I guess somebody comes off and is a reporter and writes, as I mentioned in my opening comments to you, Chairman Greenspan said so-and-so, and they run off and put that on the wires.

A few minutes later it is something else. I never know which one it is they think is important.

Is there anything that you see on the blip screen other than your comments you made earlier in your written testimony and so on that would lead you to believe that the economy is not generally in pretty good shape?

Are things going generally in the right direction?

Mr. GREENSPAN. Well, Mr. McCollum, I think we clearly have a sluggish economy, one which is growing more slowly than it has in the past and that, in part, is a function—as I indicated in my prepared testimony—of a surprising slowdown in the labor force, but to the extent that one can evaluate the quality of an economy, it is clearly better than it was in the sense that we do not have the frenetic credit expansion nor double digit money supply growth.

It is a more measured change that is occurring in the expansion of the financial system, and that is gradually improving some of the balances in our financial system which I have in past testimonies here been concerned about.

In other words, the increased leveraging of the corporate sector, the effect that has on the ratio of interest payments to corporate cash flow, the various elements within the banking system and its problems.

All of these issues are likely to be ameliorated, at least in part, by this gradual reduction in gross credit expansion and monetary growth, and in that sense, I am feeling somewhat more comfortable about the broad underlying base of the economy.

It is nonetheless true that the economy is not vibrant. It is not moving forward in a very rapid pace. I am not sure—considering the fact that we have a 5.2 percent unemployment rate—that that is all bad.

Mr. McCollum. You would be worried if it were right now, I would think. You would be worried about the economy were bursting forward?

Mr. Greenspan. I would. I would say were that the case, I think it would create very considerable difficulties for us.

Mr. McCollum. Inflationary difficulties, in particular?

Mr. Greenspan. Yes, I would—I don't want to hypothecate all the various different things that can happen from here, but I think we have come a long way without the economy tilting into recession and in that process, I think that we have ameliorated a number of the imbalances—not all—but a number of the imbalances which were engendered during the mid-1980's.

Mr. McCollum. I know you would like to get to zero inflation some day, as would Mr. Neal like to. I think everybody would in principle. But I gather from your comments that generally speaking, the policies that you have had that you have seen implemented and what is going on in the economy today kind of mesh with at least the concept that for the moment inflation is steady, it is not out of control, it is under control, it could be better, but it is, in light of the sluggishness in the economy, I assume, around where it is at the better end of your expectations for the present period?

Mr. Greenspan. No. I wouldn't quite say that. I would say as I indicated to you before we think the inflation rate is higher currently than we would like. We do, however, believe that with the changes in the rate of growth of the overall credit materials and, more specifically, the money supply rates of growth that have occurred in the last several years, plus what we envisage for the future, that that rate will come down.

We don't like to see it where it is because it is very easy to accelerate from there, as I have indicated to this committee on many occasions in the past.

We would be far, far better off at a significantly lower rate ideally to a non-inflationary rate. Whether that is literally zero or a small plus, I don't think is all that relevant, so as long as we effectively remove the expectations of inflation as a significant factor for business decisionmaking.

Mr. McCollum. Your objective, of course, is to slowly and gradually get there, which is without unduly disrupting the economy, which is essentially the past you described we are on except you think the economy is a little more sluggish than you would like.

Obviously, you don't want us to be getting there quite—in other words, in too draconian a fashion. You can be too sluggish to get there is what I am saying.

Mr. Greenspan. We are trying to balance the various forces in the economy, recognizing that they interact in a manner in which the correct policy, if one could find such a policy, will create not only the best inflation environment, but, as a consequence of that, the maximum potential long-term growth, as well.

Mr. McCollum. I thank you, Mr. Chairman.

I thank you, Mr. Neal.

Chairman NEAL. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

My first question relates—we had talked about before the—bad lunch—we talked about the effects of recession on New England. New England had such low growth, the West Coast seems to have very high growth, 4, 4.5 percent.

My question is, is our economy becoming more regionalized?

I don't recall a time when there seemed to be such disparities in different ways in the last while. Have things changed so that we are going to live with most of one part of the economy in recession, another part of the economy in boom, and other parts in degrees in between?

Is that more prevalent now than it was 15, 20, or even 10 years ago?

Mr. GREENSPAN. I haven't looked at the data in any systematic way, Mr. Schumer. I would suspect not.

Remember, in 1986, or 1985, 1986—1986, really, the spread between New England and the Southwest was about as large as I remember.

Mr. SCHUMER. I don't mean in the last two years. I mean in the last decade, in the last 15, in the last 20?

Mr. GREENSPAN. In principle, if you go back long enough, clearly it couldn't be the case. Obviously, the—in the 1850's, for example, California was always disassociated as far as economic activity was concerned from the East; and one would have expected rather significant differences.

Obviously, at some point it may have turned around. I am not sufficiently familiar with it. I would not necessarily argue that there is increased regionalization. One would assume actually otherwise as a consequence.

Mr. SCHUMER. You this so?

The second question relates to income distribution. Kevin Phillips' book has taken this town by storm. He in his book talks about how the middle class economically and in other ways is getting squeezed; in the eighties the well-to-do, the very wealthy, did much better.

Do the numbers you have bear that out?

In other words, that in the eighties, the middle income people lost proportionately compared to, say, the top one percent of the population?

Second, does it have effects for the economy?

I know many economists, or at least some, believe that the great depression, in a sense, was caused by the fact that wealth became too concentrated in the upper reaches in the late twenties. There wasn't enough money in the rest of society.

When the downturn occurred, it just kept going down and down and down.

Mr. GREENSPAN. I don't know how to answer that question specifically. See if you can re-phrase it for me.

Mr. SCHUMER. The first part is: in the 1980's, the first one you could answer, specifically, the first part of the question was has—do your numbers, the Federal Reserve Board's numbers——

Mr. GREENSPAN. That is one of my problems. We don't have Federal Reserve Board numbers.

Mr. SCHUMER. On income distribution?

Mr. GREENSPAN. No. These are Census Bureau data. The data that we have are really secondary source data.

Mr. SCHUMER. And not to be trusted?

Mr. GREENSPAN. I wouldn't want to, you know——

Mr. SCHUMER. What is your view?

Mr. GREENSPAN. The reason I am having a problem with this question——

Mr. SCHUMER. You haven't had problems with very many.

Mr. GREENSPAN. I understand that.

Mr. SCHUMER. This one wasn't intended to be a difficult one.

Mr. GREENSPAN. It is difficult because I haven't looked at these data in adequate detail in recent years. While I grant you I am aware of Kevin Phillips' remarks and I am aware of what other people are saying about this issue, I hesitate at this point to come to any conclusions because my recollection of the data is that there are very substantial amounts of interpretation required to draw various different conclusions.

So I am trying essentially to avoid an answer from—largely because I am uncomfortable with the data themselves and I am trying to remember myself what the short-falls in the data are. I am having difficulty recollecting it at this stage.

Chairman NEAL. Will the gentleman yield?

I am sort of curious, too. Let's say we had absolutely perfect data that suggested the top one percent of our society controlled roughly the same amount of financial assets as the bottom 40 percent, would that be troubling?

Mr. GREENSPAN. Well, I think there are obviously effects when you have very sharp differences in distribution of either income or wealth, largely because it tends to fragmentize the markets.

That is, you do not get large, big consumer markets for specific goods, leaving the equity issue aside.

My impression, basically, is that it does create some difficulties. On the other hand, it is also the case that large distributions of income do create probably a higher savings rate than would ordinarily occur in a society, and other things equal—I emphasize other things equal—that is a positive element.

So as far as the functioning of the economy is concerned, I think that the—it is difficult to make a judgment as to whether mal-distributions of income or wealth net on balance have significant negative impacts upon the economy, and one thing I am reasonably sure of is one cannot attribute the 1929-1932 contraction to that.

There may be effects, and I think there are people who do argue there are effects. I find the evidence myself or at least I found it over the years inconclusive either way, wholly independent of the equity question.

I would not want to argue that—certainly monetary policy shouldn't be responding to this, because I am not sure which direction we respond.

Mr. SCHUMER. OK.

Chairman NEAL. May I just comment?

You are commending clearly on—in terms of the overall economic effect of such a mal-distribution of wealth. Of course, we have a big concern with issues other than that also.

Even on those grounds, it strikes me as strange that our savings rate is so bad—in fact, as you pointed out earlier, even in relationship to our major trading partners, it is among the worst in the world, yet I imagine the mal-distribution of wealth here is probably more pronounced than it is in most of those other countries we are comparing ourselves to.

Mr. GREENSPAN. Mr. Chairman, I would say the distribution of income and wealth is only one element in the savings equation.

Chairman NEAL. You mentioned it. That is why I pursued it.

Mr. SCHUMER. In evaluating a specific economy, it is important to look at both sides of the issue. The differences between economies with respect to culture, attitudes, and the like, are far more important elements in defining the difference, the difference in the underlying savings rate than, as best I can judge, distribution of income and wealth.

Chairman NEAL. I thank the gentleman for yield.

Mr. SCHUMER. Thank you.

I am surprised, though, the Fed doesn't have data on the distribution.

Mr. GREENSPAN. We have data from the Bureau of the Census. It is not our information. We do not do anything separately in that respect except we do have a survey of consumer finances in which, as part of it, we do collect income by income class, but that is nowhere near as good as the underlying data the Census uses.

Mr. SCHUMER. On the question of the savings rate which is a conversation you and I have had for a year or two, I am becoming more and more convinced the answer why we save so little is sort of the opposite side of the coin that America has become the greatest merchandiser around.

We are the best, far and away—how are we different than the Germans, the Japanese?

God knows anyone else?

We can sell a product better than any of them. Television, everything else.

I think we have sort of encouraged because of our merchandising bent, we have sort of encouraged our people, our government, our businesses, all of them in a sense, you know, to have a dollar's worth of life on 90 cents worth of income, if you will.

Now, I don't know what you do with that. Maybe you can give preferential advertising rates to banks. I don't know. I don't have a—for the record, that is a facetious suggestion.

We have looked at all the tax benefits. We have talked about those. We have looked at IRAs.

We looked at all the various things. They may make some marginal difference. I agree with you, it is the number one question for the American economy.

It is the number one reason that the Japanese, say, buy Rockefeller Center or the British buy whatever they buy. Yet, we can't seem to change it.

We are sort of locked in. No one even has suggestions about what to do about it. That is where my thinking has evolved.

Mr. GREENSPAN. Congressman, I couldn't agree with you more. I think it is very frustrating. It is a very crucial issue which we cannot merely set aside for another day. We have to keep pursuing *this issue, try to find a means to resolve it. You don't have the choice not to.*

Chairman NEAL. Will the gentleman yield to me on this?

Isn't it clear, though, our tax laws, especially, encourage consumption and discourage savings?

We do a lot of those things in the name of consumers, but in the macro economic terms, the net effect of it is to discourage savings?

Also, when you compare our savings rate with that of Japan, there are some significant differences. We have a much higher developed Social Security system than do the Japanese. As I understand it, it says to our people you don't have to save as much for old age as maybe the Japanese person understands about his or her future.

Is that not correct?

I am not an expert on this. I understood some of these things make a big difference.

Also, I would point out to my friend, as I understand the way our economy works, there is hardly anything that encourages savings more than to know that the value of the savings will remain constant, that is, zero inflation.

I had an interesting experience many years ago. I was in China before the so-called normalization of relations between our countries. The Chinese, under a rigid communist system, were very proud of the fact that the value of their currency had not changed in, oh, decades.

It was a promise they had made to their own people that the currency wouldn't change. The Chinese, almost one of the most poverty-stricken people in the world, saved. Out of their meager income, they saved. The knew the value would remain constant.

Let me tell you an aside on that. I will tell you how strictly they enforced this. My son was young at the time and collected. When I was leaving the country, another thing they were proud of was there was essentially no crime. We would leave our hotel rooms open, there would be no worry about that.

At the time I was ready to leave, I was ready to change the money back, except I wanted to keep a few coins and bills and so on to bring home to my son. The money changer there in the lobby saw that, made the change for me. I didn't say anything. I took the coins and bills back and put them in my suitcase.

When I got home, back to the United States, those coins and bills weren't there. They had an absolute rule they were going to protect the value of their currency which meant protecting the supply of it, controlling the supply of it. They had a rule against taking coins and currency out of the country. I guess they knew I was prepared to commit this great crime. They went in there and got them.

Does the gentleman have further questions or comments?

Mr. SCHUMER. I was just going to say this is why I guess we don't get anywhere on the savings issue. Mr. Neal thinks the zero inflation bill would do it. I think abolishing advertising or something would do it. There must be some truth in between.

I have one more question, but if there is no time? It is another one a little far afield.

Chairman NEAL. Let me go to Mr. Hoagland. I will come back to you.

I have just a couple of quick ones, if I may.

Mr. Chairman, what would happen if, back to this question of foreign exchange intervention, what would happen if you just stopped? There just weren't any more?

Mr. GREENSPAN. Well, we substantially stopped the intervention during the early part of the 1980's.

Chairman NEAL. Was there any harm?

Mr. GREENSPAN. There have been innumerable periods when we stopped.

Chairman NEAL. Was any harm done by that?

Mr. GREENSPAN. There are those who think there was, yes. This is part, Mr. Chairman, of the ongoing debate.

In fact, we at the Fed, a number of months ago, had a very elaborate evaluation and discussion amongst the participants of the FOMC on very many of the points you raise. It is interesting to see there are differences, legitimate differences, which still fairly markedly occur.

Chairman NEAL. I don't want to pursue this too much. In your opinion, if we stopped, would there be great damage done?

Mr. GREENSPAN. If we did not intervene?

Chairman NEAL. Right. Just stop doing it.

Mr. GREENSPAN. My own personal view is that the advantages of intervention are relatively limited. I do think there are some occasions when I think it probably is helpful to intervene; but I would probably, on the scale of what my colleagues think, I would probably be more towards the less rather than towards the more intervention.

Chairman NEAL. I just have a final question, if I may.

Let me direct your attention to the chart on the table there entitled Bank Reserves and Federal Funds. It is the one to your right.

What is interesting to note is that the Federal funds rate has remained pretty stable over this year and the reserves have come down. That leads me to think that the emphasis is on maintaining Federal funds rate stability, or maintaining the Federal funds within some range of stability.

It seems to me that we engaged in a magnificent experiment in this country under the leadership of Chairman Volcker that was successful. It seems to me he demonstrated conclusively you can control inflation by controlling the monetary aggregates; and he did it. It was a shame that we let inflation go to the point that it took so much disruption in the economy to do it. But in any case, he did it. I think he saved the country.

As you know, I complimented you many times on your leadership at the Fed because you are continuing to target inflation and control it. It does such great harm to our country.

I just wonder if you would help clarify my own thinking. It appears to me there is some emphasis here on the Federal funds rate again that if that is so, it would be troubling to me. It would indicate to me we are moving away from controlling the aggregates, controlling inflation to trying to accomplish something else which might lead us down a dangerous road again.

Mr. GREENSPAN. Mr. Chairman, I think we look at the purpose of monetary policy to affect financial elements within the system. Very specifically, we target M2, M3 and the credit aggregate; and we are very careful to observe the interrelationship between various different levels of the Federal funds rate and the movements in these other aggregates which obviously is where the overall long-term effects as well as some short-term effects occur.

So while it is certainly the case that on a day-by-day basis we are acutely aware of what the Federal funds rate is, we are not wedded to that in the sense that that is all we do.

We are very acutely aware of what a funds rate is doing to the credit aggregates, to money supply; and, indeed, it is exactly that issue which created responses on our part a couple of weeks ago when, in effect, we were getting a response different from that which we had intended.

That did require an adjustment in the Federal funds rate in order to keep the other elements in the system on the tracks that we wanted, which is—as we view it—the fundamental thrust of monetary policy.

Chairman NEAL. Well, I don't know whether you are encouraging this or whether it is something that is just inevitable. If it is, I don't quite understand why. There is certainly in the financial press, it seems to me, an emphasis on the Federal funds rate that—I don't know how useful it is. It is a great country. People can do whatever they want.

It would seem to me if you talked more about these other elements of monetary policy, it might focus public attention more on that, with the result that the public would have a more accurate understanding of what is really going on.

Is that right or not?

Mr. GREENSPAN. I think you may be raising an interesting issue. Let me think about that.

Our job as the public sees it seems complicated enough. I don't want to make it appear to be utterly abstruse.

Chairman NEAL. That wasn't my intention either. It just seemed to me there is a greater likelihood of misunderstanding with all the attention on the Federal funds rate than if the attention was on the longer term.

Mr. GREENSPAN. I think it is a colloquy such as we are having, Mr. Chairman, where we can make our views of these elements better known. But I will certainly take under advisement your notions which I think are—it is an interesting issue.

Chairman NEAL. Mr. Hoagland.

Mr. HOAGLAND. Thank you, Mr. Chairman.

I would just like, Mr. Chairman, to ask three more questions, if possible. I know we are holding you well into the lunch hour. The information that you give us is so interesting and important that I will try to make these as quick as I can.

First, Mr. Schumer's question that he was unable to ask because he had to leave, which he also said was somewhat far-fetched, I think is very much worth putting to you in light particularly of our situation in Omaha where our unemployment rate is so low now that we are actually losing businesses that are considering locating in Omaha but going elsewhere, because there is not the labor market.

That is, is immigration any kind of a solution to our labor shortage problems in parts of the country? Do you see opening our gates a little wider, particularly in light of the talent in East Europe and the Soviet Union that would like very much to come here as helping our economy and as something that you would recommend?

Mr. GREENSPAN. Well, it is scarcely in the area of Federal Reserve interests, but it is nonetheless the case that we are looking at a labor force growth which seems inordinately slow; granted the last 6 months are probably a temporary aberration.

Even having said that, it does look as though the extraordinary growth in female participation in the labor force, which had been a major factor in the net addition to the labor force, is beginning to slow its pace in one form or the other.

Obviously, immigration can offset that, immigration obviously of skilled workers and those in the various age and cohort categories which are major participants in the labor force.

But there is no question that certainly our history underscores the extraordinary consideration that immigration has made to our economic vitality and growth, and should we begin to become concerned about an inadequate labor force growth which in turn creates, in a broad policy sense, an inadequate economic growth potential, then clearly one should evaluate this issue because it makes an obvious difference in the outcome.

Mr. HOAGLAND. Can immigration involve enough numbers of people to make a significant impact?

Mr. GREENSPAN. As far as I understand it, the United States still attracts vast quantities of people who would be delighted to come to our shores and participate in what they perceive as unbelievable prosperity.

Mr. HOAGLAND. And such talented people, too?

Mr. GREENSPAN. Indeed.

Mr. HOAGLAND. The FMOC in its mid-year review raised the estimate of inflation for the current year compared with the February estimate which means that for about two years now, we have been having trouble with inflation, as I understand it.

At the same time, our economy seems to be performing below what the Fed considers to be non-inflationary potential real growth of about 2.5 percent.

What are your thoughts? I know you have addressed this subject before this morning repeatedly. I wonder if you might be able to capsulize for us how you might approach dealing with the problem of having inflation somewhat higher than we would like, having growth somewhat lower than we would like?

Mr. GREENSPAN. I think the solution to that is clearly a lower budget deficit. To the extent that budget deficit comes down in a significant way, I would suspect real long-term interest rates will fall accordingly, and that would create an increased mix towards capital investment, presumably productivity-inducing capital investment, and that would be a major factor in bringing our growth rate up from its current sluggish levels.

Mr. HOAGLAND. I missed some of your earlier testimony. Do you agree the summit target of $50 to $55 billion in deficit reduction is appropriate?

Mr. GREENSPAN. I think that that is the appropriate order of magnitude, all things considered; $50 to $55, $55 to $60, somewhere in this area.

Mr. HOAGLAND. Mr. Chairman, on previous occasions we talked about my mother.

Mr. GREENSPAN. I remember.

Mr. HOAGLAND. She recently has been asking me about the risk of a debt liquidation cycle. She notes junk bonds have been marked down in price. S&L assets are going to be sold at big discounts by the RTC. Real estate prices are falling in several parts of the country.

There is even a question about government support for some agency securities which are not full faith and credible obligations of the U.S. Government. Total debt is now about 1.8 times the size of GNP, at least in 1989 it was, which is way above past levels. This all has meaning in the Midwest, in Omaha.

How can we bring individual corporate and government debt levels down without encouraging the harsh consequences of a debt liquidation panic, she wants to know.

Mr. GREENSPAN. Congressman, I had no difficulty even with my little colloquy with Representative Schumer on answering questions put by this panel. Your mother is creating a problem for me.

In all seriousness, though, I think that these are hypothetical types of things. You can set up all different forms of scenarios, concerns that we have. Fortunately, the vast majority of the concerns that we have don't materialize.

I do think it is important for us to focus on getting the budget deficit down in a stable monetary environment and much of those other distortions which are created by inflationary processes generally I think would be significantly subdued.

We do have a very dynamic economy. Lots of things happen. While most of it is good, there are clearly negatives that are occurring all the time.

I think one of the great things about a market economy is it is a self-curing process and what I think policy is for government is to create the environment which enables the markets to work most efficiently to do that.

Mr. HOAGLAND. Well, thank you for your patience and giving as much time this morning as you have.

Mr. GREENSPAN. My regards to your mother.

Mr. HOAGLAND. Thank you, Mr. Chairman.

I want to pass that on.

Chairman NEAL. I want to invite your mother to come testify one of these days. I think she might be the only person I am aware of that would equal the distinguished Chairman of the Federal Reserve Board and the previous Chairman of the Federal Reserve Board in confusing the Members of this panel.

Mr. GREENSPAN. I can assure you, Mr. Chairman, if she comes to testify, I will come into the audience and watch.

Chairman NEAL. Learn a few lessons.

Mr. Chairman, thank you for being with us this morning.

The subcommittee stands adjourned subject to the call of the Chair.

[Whereupon, at 12:50 p.m., the hearing adjourned, subject to the call of the Chair.]

APPENDIX

July 24, 1990

Statement by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy
House Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

July 24, 1990

Mr. Chairman and Members of the Committee, I am pleased to be here today to testify in connection with our semiannual Monetary Policy Report to the Congress. In my prepared remarks this morning I shall discuss, as is customary on such occasions, current and prospective economic conditions and the Federal Reserve's objectives for money and credit growth over the period ahead. Two areas of particular note at present, with potential implications for the conduct of monetary policy, are the ongoing restructuring of credit flows in the U.S. economy and the prospects for a significant cut in the federal budget deficit. shall pay special attention to these topics in my statement.

Economic and Financial Developments Thus Far in 1990

When I came before this Committee in February, I characterized the economy as poised for continued moderate expansion in 1990, and, in large measure, developments so far this year appear to have borne that statement out. Real GNP grew at a 2 percent annual rate in the first quarter, and indicators of economic activity for the second quarter suggest a further rise, though perhaps at a somewhat slower rate. Within this whole, however, the various sectors have moved along at different paces.

On the distinctly positive side, exports have shown solid gains, buoyed by expanding markets abroad. The impetus from international trade has been important in the pickup in industrial production this year.

In contrast, the news coming from the household sector in recent months has had a softer cast to it. Consumers appear to have pulled back a bit, as the slower overall pace of expansion and the more pronounced weakness in certain parts of the country--especially the Northeast--seem to have taken some toll on confidence in the economic outlook. Moreover, having accumulated large stocks of automobiles and other consumer durables earlier in the expansion, consumers could be more selective about when to purchase replacements. Sales of new homes also have weakened, deterring building activity.

There are other pluses and minuses, as well, in the economic picture--by sector and by region. But, on balance, the economy still appears to be growing, and the likelihood of a near-term recession seems low, in part because businesses have been working hard to keep their inventories in line with sales trends.

Although output overall grew rather modestly over the first half, the unemployment rate remained at its lowest level in almost 20 years. Over the past year, as employment has decelerated, so too has the labor force, in part reflecting a surprising decline in labor force participation rates for young people. Some flattening in the aggregate participation rate would be consistent with evidence that many individuals now perceive job opportunities as less abundant. Differences from past cyclical experiences, however, suggest that other factors also must be at work--if, in fact, the current pattern represents something more than noise in the data. This development certainly bears watching, for it may have implications for potential output growth.

Be that as it may, with hiring proceeding at a less rapid pace, the rate of increase in wages appears to have leveled out from its earlier upward trend. The core rate of inflation in consumer prices, proxied by abstracting from movements in food and energy prices, picked up sharply in the first quarter, but has moderated in recent months. This moderation has been concentrated in the prices of goods, perhaps reflecting the ebbing of capacity pressures in a number of industries, while service price inflation has shown little sign of abating.

In 1990, Federal Reserve policy has continued to be directed at sustaining the economic expansion while making progress toward price stability. Ultimately, the two go hand in hand: A stable price level sets the stage for the economy to operate at its peak efficiency, while high inflation inevitably sows the seeds of recession and wrenching readjustment. In the short run, however, the risks of inflation, on the one hand, and of an economic downturn, on the other, must be weighed in the policymaking process. The Federal Reserve saw those risks as about evenly balanced over the first half of the year and made no adjustments in monetary policy.

Throughout this period, which has been marked by dramatic changes in the flow of funds through depository institutions, the Federal Reserve has been paying particularly close attention to conditions in credit markets. Evidence of a tightening of terms and reduced availability of credit has gradually accumulated, to the point where it became apparent in recent days that some action by the monetary authority was warranted. A number of indicators have been pointing in this direction, including the behavior of the monetary aggregates. Growth in M2, for example, which stalled out in the spring, has failed to strengthen materially, suggesting that the degree of financial restraint in train might be greater than anticipated or than appropriate to the evolving economic situation. This restraint is a function of developments in the credit markets, independent of monetary policy. The recent decline in the federal funds rate to 8 percent, as a consequence of our action to reduce slightly the pressures in reserve markets, represents an effort to offset the effects of greater stringency in credit markets.

Other market interest rates generally rose early in 1990, as it became apparent that the economy was not as weak as many had thought. Long-term yields were most affected, increasing a full percentage point by early May. Subsequently, however, signs of a softening of activity prompted a reversal of much of that runup. Rates on long-term securities remain about 1/2 percentage point above their year-end levels, but money market quotes are now little changed on balance. Throughout this period, rates on Treasury bills have remained somewhat higher than usual relative to those on private instruments, probably in part reflecting the large amount of bill issuance necessary to fund working capital for the RTC.

The runup in market interest rates early in the year was one factor behind the sharp slowing in money growth over the first half of 1990. M2, which had been running close to the top of its target range in February, posted no net increase between March and June. This weakness, which moved the aggregate close to the bottom of its range, was too abrupt to be accounted for fully by the rise in market rates, however. Another of the factors at work was the restructuring of financial flows. One aspect of this restructuring was the closing of insolvent thrifts by the RTC and sale of their deposit bases. Although the RTC's activities do not directly affect M2, the availability of huge blocks of deposits to the remaining thrifts and banks lessened their need to raise rates to draw in funds. In combination with the more cautious attitude depositories have exhibited toward expanding their balance sheets, the deposit transfers contributed to an unusual degree of inertia in the pricing of retail deposits. Households responded to the relatively low returns on deposits by looking elsewhere, as suggested by heavy flows into stock and bond mutual funds and sizable noncompetitive tenders at Treasury auctions. Nevertheless, while the movements in yield spreads can account for a good share of the slump in M2 growth, a portion of it still requires explanation.

The cause for the meager growth this year in the broader monetary aggregate, M3, is clearer: The RTC closed down a very large number of S&Ls, taking many of those institutions' assets onto the government's balance sheet and thereby effectively reducing the overall funding needs of the depository system. In addition, increased loan losses and the phasing-in of tighter capital requirements circumscribed the expansion of credit at many other thrifts and banks. With depository credit growth limited, M3--which contains much of the associated funding--essentially stalled. By June, M3 growth was well below the 2-1/2 percent lower bound of the target range the FOMC had set in February.

That range had itself been reduced a full percentage point from the target provisionally set last July in recognition of the potential effects of the ongoing contraction of the thrift industry. Lacking historical experience with a financial restructuring like the current one, however, it was unclear exactly how the flows would end up being redirected through the financial system and, in particular, how much of the thrift lending would be picked up by commercial banks. While the economy more broadly is about where we expected it to be, the configuration of the financial system is somewhat different, leading to less M3 growth than had been anticipated.

Credit Conditions

The weakness in the monetary aggregates in part signals a change in the behavior of depository institutions, with potential for affecting overall credit provision. The conservative pricing of retail and wholesale deposits represents one aspect of their efforts to widen profit margins. In light of concerns about their capital positions, banks and thrifts also have reined in lending activity and imposed stiffer terms on loans.

The change in credit supply conditions may have significant implications for borrowing, spending, and policy. I would not call this change a "credit crunch," as those words connote a contraction of lending on a major scale, with many borrowers effectively shut out of credit markets, regardless of their qualifications. We are not seeing symptoms of that kind of widespread, classic crunch, as in the past when deposit rate ceilings or usury ceilings limited the market's ability to adjust and forced cutoffs of credit. But I can well appreciate that my view on this topic may be perceived as a semantic nicety by a borrower who today is suddenly unable to get a loan on the terms formerly available. To the borrower, it makes little difference why the lender is pulling back or how pervasive the change in credit conditions is.

From a policymaker's perspective, however, it is essential to sort the issues out. This means discerning the breadth and depth of the shift in credit conditions, its causes, its effects, and the extent to which it may ultimately be a desirable development. Clearly, the verdict is not yet in on the current episode; in economics we are seldom able to make a definitive diagnosis until well after the fact, but to do our job we must hazard some answers.

First, what do we observe? The evidence on this score continues to grow; numerous reports indicate that depository institutions and other lenders have become more selective in extending credit. In addition, Federal Reserve surveys of large banks support this sense that terms have been tightened in particular parts of the country and on certain types of loans. Especially hard-hit have been financings for mergers and LBOs, commercial real estate, and construction and development. There also is evidence that small and medium-size companies, as well as the poorer quality credits among the larger firms, have faced some tightening of credit availability. The change in credit conditions has taken various forms, including tougher standards for credit approval, higher collateral requirements, increases in interest rates, and, in some cases, loans have been simply unavailable. Even investment-grade corporations appear to be facing slightly higher costs in accessing bank credit facilities. At the same time, a huge widening of spreads on less-than-investment-grade bonds has effectively shut down that market to most new issues.

But on a number of other types of credit, changes in price and non-price terms appear to have been relatively minor. For example, the rates on residential mortgages, consumer loans, and the debt of investment-grade corporations have remained about in their usual alignment with other market interest rates. Because these credits may trade on securities markets and thereby access a broad range of investors, the interest of banks and thrifts in holding the obligations in portfolio has little, if any, effect on the cost to borrowers. These obligations account for a major share of the credit extended in the economy, and hence the slowing of depository credit and the sluggish behavior of the monetary aggregates--while indicative of some tightening of credit--likely overstate the impact of the depositories' behavior on economic activity.

No doubt a sizable portion of lenders' increased reluctance to commit funds for certain purposes reflects a natural and healthy reaction to a slowdown in growth as the economy moves closer to capacity constraints. Prospects for continued strong production and sales increases fade, and the odds rise that some borrowers will prove unable to meet their obligations. In other words, part of the ongoing shift in credit conditions is what amounts to a regular cyclical event. But there is more to it than that. Through one avenue or another, the change in credit standards has its roots in part in the excesses of the 1980s. The weaker credits extended during that decade have come home to roost, and in so doing have impinged to varying degrees on the current availability of credit.

Perhaps the clearest example is the real estate sector and its principal lender, the thrift industry. Those S&Ls that were the freest with their funds exist no longer, having been closed by the RTC, and the remaining S&Ls face tighter regulations constraining their lending. The resulting void has been filled quite effectively for home mortgage borrowers, with highly developed secondary markets drawing funds in from elsewhere. For these borrowers, the shrinkage of the thrift industry does not represent a significant decline in intermediation services. But many other clients of thrifts, whose debt is less easily securitized, have been hard-pressed to find alternative sources of funds. Moreover, lax lending standards by both thrifts and banks contributed to overbuilding in commercial real estate, which has added to problems for lenders to this industry.

Rising capital requirements for banks and thrifts have interacted with large losses on soured loans and the financial market's distaste for providing additional capital to the institutions taking these losses. This interaction has resulted in strong incentives for depository institutions to conserve capital. Their efforts to build larger capital cushions, in turn, have been manifest in a somewhat more cautious approach to lending, as well as a stepped-up effort to sell off assets by, for example, securitizing loans. Partly as a result of tighter credit conditions, the growth of credit, as measured by the change in the debt of domestic nonfinancial sectors, has come down into closer alignment with the expansion of nominal GNP. This process, which reflects a somewhat more cautious approach on the part of borrowers as well, is not an aberrant restrictive phase in the life of the financial system, but rather a return to what had been the norm prior to the 1980s.

To be sure, when you go from excess credit creation to normal, it can feel like a tightening. And in that sense credit conditions have tightened. Many of the loans made during the 1980s should not, by historical standards of creditworthiness, have been made. As standards reverted closer to normal, those weaker borrowers have been finding it far more difficult to access credit.

In addition, however, depository institutions appear more recently to be lending with greater caution in general. As a result, even creditworthy borrowers may have to look harder for a loan, put up more collateral, or pay a somewhat higher spread. For the nation as a whole, the tightening of credit standards will leave the financial system on a sounder footing and contribute to economic stability in the long run. Nevertheless, in the here and now, the tightening is beginning to have very real, unwelcome effects. Diminished credit availability can constrain firms' spending, for example, limiting more of them to internally generated funds. It is difficult to discern the dividing line between lending standards that are still healthy and those that are so restrictive as to be inconsistent with the borrower's status and the best interests of the lender in the long run. In recent weeks, however, we may have slipped over that line. Such developments can, and do, occur independently of central bank actions, and can have important influences on spending and output. Thus the Federal Reserve must remain alert to the possibility that an adjustment to its posture in reserve markets might be needed to maintain stable overall financial conditions.

As best we can judge, the change in credit conditions currently is exerting a slight additional degree of restraint on the economy. The process of credit restraint may not have reached completion and some of its effects may not yet have been felt; hence it will require continued scrutiny. However, the tightening should eventually unwind as displaced borrowers find alternative sources of funds and as the banking system rebuilds its capital.

This restraint has implications for monetary policy at present, and the ongoing restructuring of the financial system has implications for the conduct of policy over the foreseeable future. It is clear that the financial restructuring will affect the channels through which policy actions are transmitted ultimately to economic growth and inflation; some will be diminished and others augmented. In these circumstances, the Federal Reserve has emphasized a flexible approach to policymaking, which includes attention to a wide range of economic and financial indicators.

Ranges for Money and Debt Growth in 1990 and 1991

At its meeting earlier this month, the FOMC reaffirmed the 1990 range of 3 to 7 percent it had set for the growth of M2. With the thrift industry likely to continue to shrink at a good clip and commercial banks expanding more circumspectly, depository institutions are not expected to be bidding aggressively for funds. As a result, although banks may replace more of their managed liabilities with retail deposits, M2 could well remain in the lower half of its target range through year-end. In view of changing credit flows, a slow rate of expansion in M2 seems consistent with continued moderate growth in output, but any pronounced weakness in the aggregate that drops it below its current range might represent greater monetary restraint than is desirable this year.

Looking ahead to 1991, the Committee lowered the M2 range by 1/2 percentage point on a provisional basis. We believe that this range is consistent with the continuation of measured restraint on aggregate demand--a necessity in the containment, and ultimate elimination, of inflation. Such restraint need not be a barrier to sustained growth. Indeed, it is a crucial requirement. As I suggested earlier, one thing that surely would jeopardize the current expansion would be for inflation to move upward, rather than downward, from the recent plateau.

FOMC members and other Reserve Bank Presidents generally foresee the policy embodied in the money ranges as leading to both sustained growth and diminished inflation in the period ahead. For 1990, their expectations center on an inflation rate in the 4-1/2 to 5 percent range, with real GNP growth of about 1-1/2 to 2 percent. But with this year's slow growth helping to relieve pressures on resources, expectations for 1991 incorporate both somewhat lower inflation and somewhat higher real growth, at a rate closer to that of growth in potential output.

The path of M3 consistent with these projections has been heavily affected by the changes in financial intermediation in recent quarters. Taking into account the current lending posture of the commercial banks and remaining thrifts, we now expect the closures of insolvent thrifts to show through in very subdued growth in M3.

Accordingly, the FOMC voted to lower the 1990 range for growth of this aggregate to 1 to 5 percent. This action does not signal a tighter policy stance, but rather our recognition that financial markets have been adjusting to the RTC's activities in a somewhat different manner than we had anticipated, making the lower M3 target appropriate. In view of the considerable uncertainties about both the scale of RTC activities next year and the speed with which the banking industry will approach a more comfortable capital position, the new 1990 range was carried forward unchanged into 1991 on a tentative basis.

Overall debt growth during the rest of this year is expected to remain around the midpoint of its reaffirmed 5 to 9 percent monitoring range. The nonfederal sectors now appear to be increasing their debt about in line with nominal income growth, with the rapid pace of mortgage borrowing in recent years slowing into the single digits and corporate leveraging activity slackening. Growth of total debt in 1990 is likely to exceed that of nominal GNP, however, as the federal government's borrowing to fund RTC activities is expected to boost the total by roughly 3/4 percentage point.

For 1991, the FOMC has provisionally reduced the monitoring range for domestic nonfinancial sector debt to 4-1/2 to 8-1/2 percent. Debt growth in this range should be adequate to support continued economic expansion, while avoiding the excessive leveraging that characterized much of the 1980s.

A number of uncertainties come into play in the process of judging the outlook for the economy over the next year and a half. Of particular concern in the context of monetary policy are the likely extent and persistence of the tightening of credit terms, the prospective path of potential output growth--especially in view of the recent slowing in the labor force--and the outlook for fiscal policy. It is the last of these that is the focus of the remainder of my comments today.

Fiscal and Monetary Policy Interaction

The determination displayed by the Congress and the Administration in their efforts to come to an agreement on cutting the deficit has been enormously heartening to all who are concerned about the long-run health of the U.S. economy. As a nation, we have been saving too little and borrowing too much; significant progress on the federal deficit would be an important step in rectifying this situation. As you know, I favor not only eliminating the deficit, but also ultimately bringing the government's accounts into surplus over time to compensate for the private sector's tendency to save relatively little. In the long run, the nation's saving and investment behavior is crucial in determining its productivity and hence its standard of living.

Major, substantive, credible cuts in the budget deficit would present the Federal Reserve with a situation that would call for a careful reconsideration of its policy stance. What adjustment might be necessary, and how it might be timed, cannot be spelled out before the fact. The actions required will depend on the constellation of other influences on the economy, the nature and magnitude of the fiscal policy package, and the likely timing of its effects. I can only offer the assurance that the Federal Reserve will act, as it has in the past, to endeavor to keep the economic expansion on track.

Concerns that the Federal Reserve would be unable to offset undesirable macroeconomic effects of a budget pact are, I believe, largely unfounded. It is true that, in general, monetary policy cannot be calibrated extremely finely in response to economic developments, as we are all subject to imperfect data and an imperfect understanding of the myriad economic interrelationships of the real world. However, some doubts seem to focus on whether the various lags involved permit monetary policy to catch up to a change in the fiscal stance. I am less concerned on this point. We can decide that a policy adjustment is appropriate and implement it fully, all in the same morning if need be, and the effects of the change will show through to interest rates and financial asset prices almost immediately. Granted, the impact on economic growth and inflation will be spread out over several quarters, but this is true of changes in fiscal policy as well.

In the final analysis, no one can guarantee that growth in the economy will proceed smoothly, without a hitch on a quarter-to-quarter basis. Nevertheless, a major cut in the budget is unquestionably the right thing to do. Because the federal government has been borrowing too much for too long, it is well past time to reduce the government's draw on credit markets and to free up more resources for enhancing investment and production by the private sector. In this way, fiscal policy, by augmenting national saving, will be doing its part to promote maximum sustainable economic growth. With monetary policy similarly keeping sight of its long-run goal of price stability, the two together will have set a favorable backdrop for vibrant and enduring economic growth.

For use at 9:45 a.m., E.D.T.
Wednesday
July 18, 1990

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 18, 1990

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 18, 1990

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 for 1990 and 1991

The Federal Reserve delivered its initial Humphrey–Hawkins report of 1990 to the Congress in February, and the period since then has been an especially challenging one for monetary policy decisionmaking. The already difficult task of moving a quite fully employed economy toward price stability without contractionary mishap has been complicated by a variety of disturbances to business activity and financial markets – among them developments that distorted some of the basic indicators of the Federal Reserve's influence on the economic system.

On the whole, events in the economy have been broadly in line with the projections for 1990 contained in the February monetary policy report. Inflation has been somewhat greater on average than most members of the Federal Open Market Committee and other Reserve Bank presidents expected in February; however, this mainly reflected the influence of transitory factors early in the year, and price increases recently have been more moderate. Meanwhile, the economy has continued to expand, but apparently rather sluggishly overall since the winter.

While these aspects of the economic situation were important elements in the FOMC's review of its policy plans earlier this month, the Committee also gave careful attention to developments in financial markets. Although market interest rates had changed little on net since February, slow growth of the monetary stock and other evidence in hand pointed to a small but significant tightening of credit supplies. This implied greater effective restraint on aggregate demand in the months ahead than was thought desirable, and in the past week the System shifted to a slightly more accommodative stance in the provision of reserves to depository institutions. As a result, the overnight federal funds rate, which had fluctuated narrowly around 8¼ percent throughout the first half of the year, has declined to about 8 percent, and other market rates of interest also have eased a bit in recent days.

Developments Thus Far in 1990

In the early part of 1990, economic activity appeared to be regaining momentum, a development that reduced previous concerns about recessionary risks. At the same time, even discounting weather-related spurts in food and energy prices and an unusual bunching of price increases for some other items, there appeared to be no abatement in underlying inflationary pressures. Through the first quarter, M2 remained near the top of the annual range set by the FOMC, and although M3 was near the lower bound of its range, this weakness appeared consistent with the anticipated effects of the restructuring of the thrift industry.

The Federal Reserve maintained a steady pressure on reserve positions during the first quarter, rather than extending the sequence of easing steps that had fostered a drop in the federal funds rate of 1½ percentage points between June and December of 1989. However, in keeping with the tenor of most of the economic data released during the quarter, other interest rates generally moved higher, particularly at the long end of the yield curve. This shift suggested that market participants had reevaluated the prospects for moderating inflation and a further easing of monetary policy. Early in the year, bond yields in the United States rose along with rates in Japan and Western Europe, as developments in Eastern Europe suggested a further spur to worldwide economic activity, carrying the potential for greater inflation and heightened pressures on a limited international pool of savings.

In the second quarter, some of the weather-related increases in food and energy prices that had caused inflation to pick up earlier in the year were reversed, and price increases for many other goods and services moderated. Inflation trends remained in the range prevailing over the previous three years, though price pressures in the industrial sector gave signs of some easing. The incoming information pointed to a sluggish pace of economic expansion; most notably, growth in private sector employment slackened, consumer spending flattened, and real estate markets weakened. Moreover, advance indicators in some sectors – particularly durable goods orders and construction contracts – gave no evidence of a significant pickup in the second half. With the economy appearing somewhat less buoyant, over May and June bond yields in the United States retraced some of their earlier increases. Long-term rates in Japan and West Germany also declined, but by much less, with the result that yields in those countries have risen appreciably this year relative to those in the United States.

In foreign exchange markets, the dollar has depreciated somewhat on balance thus far this year, under the influence of a diverse set of economic, financial, and political developments around the world. The dollar has appreciated slightly in terms of the yen, while depreciating somewhat in terms of the German mark and other currencies of the EMS exchange rate mechanism and somewhat more in terms of the Swiss franc and pound sterling.

The monetary aggregates flattened out during the second quarter, and by midyear M2 was in the lower half of its annual range and M3 had fallen below the lower bound of its annual range. The weakness in the monetary aggregates mainly, though not wholly, reflected a rechannelling of credit flows away from depository institutions. Total borrowing by domestic nonfinancial sectors moderated only a little in the first half of 1990 from the pace of 1989, and growth in the aggregate debt of these sectors was in the middle of the FOMC's monitoring range. However, the proportion of lending accounted for by depositories was down substantially. Much of the decrease related to the shrinkage of savings and loan associations: Marginal institutions continued to retrench, and the Resolution Trust Corporation transferred large volumes of assets to banks and onto its own books in the course of closing failed thrift institutions. Meanwhile, concerns about credit quality and pressures on capital positions led banks to adopt more cautious lending postures and to hold down asset growth.

The weakness in lending by depositories was reflected dramatically in the behavior of M3; this aggregate, encompassing managed liabilities as well as M2 deposits, comprises most of the liabilities used by these institutions to fund credit extensions. With depository credit damped, not only were managed liabilities weak, but banks and thrifts did not bid aggressively for retail funds – thereby contributing to reduced growth of M2. In addition, increases in expected returns on stocks and bonds may have restrained expansion of this aggregate, although some portion of the slowdown in M2 remains unexplained by changes in relative yields or income. The weakness in depository credit and the monetary aggregates likely has had, to date, only limited effects on spending: The bulk of the credit formerly supplied by depositories has been provided by other lenders, in part through the securities markets, with little change in the terms to most borrowers.

Monetary Objectives for 1990 and 1991

In reevaluating its ranges for money and credit for 1990 and in establishing tentative ranges for 1991, the FOMC had to take account of the redirection of credit flows away from depository institutions and the resulting effect on the growth of the financial aggregates relative to spending and prices. In February, the Committee expected that the continued shrinkage of the thrift industry would damp growth in M3; to take account of this, it lowered the M3 range for 1990 to 2½ to 6½ percent, one percentage point below the range set tentatively in July 1989. However, the contraction of thrift assets has been faster than anticipated, in part because of the step-up in RTC activity, and bank credit has expanded less rapidly. As a consequence, through June, M3 grew at an annual rate of only 1¼ percent from its fourth-quarter 1989 base.

Barring a marked slowdown in RTC activity or a significant strengthening in bank credit, M3 growth is likely to remain sluggish over the balance of the year. As in the first half, the weakness in M3 growth is expected to be associated with a further substantial increase in velocity – the ratio of nominal GNP to money – rather than with substantial restraint on overall credit supplies. Recognizing this unusual behavior of M3 velocity, the FOMC voted in early July to reduce the M3 range for 1990 to 1 to 5 percent. At the same time, the Committee reaffirmed its range of 5 to 9 percent for total growth in the debt of domestic nonfinancial sectors. The Committee seeks to ensure that credit will remain available in amounts and at terms compatible with moderate expansion of the economy, and it will continue to assess the implications of developments at depositories for credit conditions more generally.

As noted above, the contraction of the thrift industry and the moderate growth in bank credit also has affected the growth of M2, as potential inflows of retail deposits have outpaced the needs of depository institutions for such funds. The velocity of this aggregate has risen, unexpectedly, but less than that of M3: Growth of M2 from its fourth-quarter base through June was at a 3¾ percent annual rate, within its annual range, though in the lower half. M2 velocity is likely to increase further over the second half of the year; however, a substantial slowing of M2 could suggest more restraint than would be consistent with sustained upward momentum of the economy, and thus the Committee reaffirmed the established range for M2 growth for 1990.

In setting tentative ranges for 1991, the Committee faced more than the usual uncertainty about the growth of money that would foster its objectives of sustained expansion and a gradual abatement of inflation. Developments in credit markets will be shaped not only by the special factors that have altered patterns of intermediation thus far this year, but also by the outcome of the current deliberations regarding the federal budget. At this point, the forces that recently have diminished the role of depository credit seem likely to persist for some time, and they may foster further upward shifts in monetary velocities, albeit probably smaller ones than now appear in train for 1990. To be sure, though, subsequent events may dictate adjustments to the ranges next February, when they are reexamined in light of developments over the second half of this year.

For growth in M2, the Committee tentatively adopted a range of 2½ to 6½ percent – one-half percentage

Ranges for Growth of Monetary and Credit Aggregates

Percent change, fourth quarter to fourth quarter	1989	1990 Adopted in February 1990	1990 Adopted in July 1990	Provisional for 1991
M2	3 to 7	3 to 7	3 to 7	2½ to 6½
M3	3½ to 7½	2½ to 6½	1 to 5	1 to 5
Debt	6½ to 10½	5 to 9	5 to 9	4½ to 8½

point below the 1990 range. The adjustment is consistent with the Committee's intention to move over time toward the low trend rates of monetary expansion that would be consistent with price stability. At the same time, the range is expected to allow for sufficient expansion of money to sustain moderate growth in the economy. There may be some further upward shift in velocity, but the range should be wide enough to accommodate considerable variation in credit market conditions.

The range for growth of M3 was tentatively set at 1 to 5 percent, the same as that now in effect for 1990. Growth of this aggregate is especially sensitive to the pattern of credit flows. Thus, the continuing downsizing of the thrift industry is likely to result in slower growth of M3 than of M2 again next year, as managed liabilities in the broader aggregate run off. It also is likely to mean a substantial further increase in M3 velocity. Given that growth of this aggregate currently is running along the lower bound of the new range for 1990, even if the pace of credit flows at banks and thrifts were to pick up somewhat, M3 growth between 1 and 5 percent should be consistent with the Committee's basic objectives.

For debt, the FOMC adopted a tentative monitoring range of 4½ to 8½ percent, a half percentage point below the range for 1990. The Committee viewed slower growth of debt, more in line with the expansion of nominal income, as a healthy development for the economy. The rapid expansion of debt over the past decade, relative to the ability to service it, occasioned many of the difficulties with asset quality now facing our lending institutions.

Economic Projections for 1990 and 1991

The members of the FOMC and the Reserve Bank presidents not currently serving as members believe that the monetary ranges for 1990 and 1991 are consistent with achievement of sustainable economic growth and a reduction of inflation over time. Most of them expect that the pace of expansion will be moderate over the remainder of 1990 and through next year, with the central tendency of their forecasts of real GNP growth being 1½ to 2 percent over the four quarters of 1990 and 1¾ to 2½ percent over the course of 1991.

Demand from abroad is likely to provide support for continued growth in U.S. production and employment. At current exchange rates, U.S. producers appear to be in a position to compete effectively in most international markets, and economic activity is growing relatively rapidly on average in other major industrial countries. In time, export demand should be bolstered by the shift toward more open, market-based economic systems in Eastern Europe; although the continental European nations may be most immediately affected by these developments, given the high rates of capacity utilization in those economies, the United States is likely to benefit both directly and indirectly from the increased demand for consumer and capital goods.

In the aggregate, demands from sectors outside of exports are unlikely to provide much impetus to manufacturing activity. Defense procurement is declining in real terms. And there is little prospect of a substantial resurgence in motor vehicle production: High levels of auto sales in the past several years appear to have satisfied demands that were pent up during the deep economic slump of the early 1980s. Demand for construction materials and equipment probably also will remain subdued, because building activity will be damped by the current overhang of vacant residential and commercial space. That overhang, more than any disruption of credit flows, explains the current weakness in construction, and, especially in the case of office building, it will take some time for existing space to be absorbed and to lay the base for a solid upturn in activity.

In sum, the growth of total output projected for 1990 and 1991 probably will involve rather slow gains for

Economic Projections for 1990 and 1991

	FOMC Members and Other FRB Presidents		Administration
	Range	Central Tendency	
1990			
Percent change, fourth quarter to fourth quarter			
Nominal GNP	5 to 6½	5½ to 6½	6.8
Real GNP	1 to 2	1½ to 2	2.2
Consumer price index	4 to 5	4½ to 5	4.8[1]
Average level in the fourth quarter, percent			
Civilian unemployment rate	5½ to 6½	5½ to 5¾	5.6[2]
1991			
Percent change, fourth quarter to fourth quarter			
Nominal GNP	3½ to 7	5¼ to 6½	7.2
Real GNP	0 to 3	1¾ to 2½	2.9
Consumer price index	3½ to 5	3¾ to 4½	4.2[1]
Average level in the fourth quarter, percent			
Civilian unemployment rate	5¼ to 7	5½ to 6	5.6[2]

1. CPI-W. FOMC forecasts are for CPI-U.
2. Percent of total labor force, including armed forces residing in the United States.

the goods-producing sectors of the economy. The service-producing industries are likely to continue to be the locus of important increases in output and, especially, employment. Demands for a wide range of services have remained robust thus far this year, and demographic trends suggest that such sectors as medical care and education will continue to experience appreciable growth.

The overall growth in economic activity forecast by the Board members and Bank presidents for the period ahead is expected to be consistent with a slight easing of pressures on resources and a diminution of inflation. With respect to the labor market, the central tendency of the forecasts for the civilian unemployment rate is 5½ to 5¾ percent in the fourth quarter of this year and 5½ to 6 percent in the final quarter of 1991; the jobless rate has fluctuated narrowly at a little below 5½ percent since late 1988. Moderate growth in demands on industrial capacity should be conducive to an extension of the recent more favorable trends in producer prices for intermediate and finished goods, which were, respectively, virtually unchanged and up just 3 percent in the past twelve months.

Inflation at the retail level also should be damped over the remainder of this year by favorable developments in the energy sector. Despite the very recent upturn in crude oil prices, gasoline prices are widely expected to decline in coming months, as the return of refinery output to normal levels alleviates the tightness that has characterized the product market. With inflation for other goods and services expected to remain below the first-quarter pace, the central tendency of the policymakers' forecasts of the overall consumer price index is for an increase of between 4½ and 5 percent over the four quarters of 1990—compared with the 5¾ percent annual rate of increase recorded during the first five months of the year. The lower trajectory of the CPI is projected to be sustained in 1991, with forecasts for the year centering on the 3¾ to 4½ percent range.

The Administration's economic projections, presented in connection with its mid-session update of the budget, indicate similar expectations about inflation trends but a more favorable outlook for real GNP. As a result, the Administration's projection of nominal GNP growth is somewhat above the central tendency of those of the FOMC participants, and might imply the need for faster monetary growth than is currently contemplated by the Committee. These differences must be regarded as small, however, relative to the degree of uncertainty that attaches to any prediction of the economy—and, in particular, of the short-run relation between growth in GNP and money stock. More important, the differences do not signal any basic inconsistency between the goals of the Federal Reserve and the Administration, for the Federal Reserve would welcome a more rapid expansion of output that occurred in the context of solid progress toward price stability.

Section 2: The Performance of the Economy During the First Half of 1990

Activity in many sectors of the economy followed an erratic course during the first half of the year, in part because of transitory factors, such as last winter's unusual weather. On balance, production expanded further during the first half of 1990, but evidently no faster than the reduced pace of 1989. The comparatively slow rate of growth largely reflected weaker spending by domestic businesses and households, while merchandise exports apparently remained on a fairly strong growth path. Although job creation in the private sector of the economy has slowed this year, the civilian unemployment rate has remained near 5¼ percent, the lowest level in nearly twenty years.

Prices rose sharply early in the year, but the increases moderated this spring. In the first quarter, there were large weather-related surges in food and energy prices and a bunching of increases in prices of some other goods and services. Given the character of the spurt, most analysts—and policymakers in the Federal Reserve—judged that the runup in aggregate price indexes overstated underlying inflation trends. In the event, some of the transitory elements of the earlier spurt were reversed in the spring and inflation moved down. Despite the recent slowing, however, the twelve-month change in the CPI as of May, at 4.4 percent, was about the same as that recorded for each of the past three years. In part, the persistence of inflation during a period of slower economic growth reflects continued cost pressures from relatively tight labor markets and weak productivity performance. However, there have been encouraging signs, particularly at the earlier stages of processing, that an easing of resource constraints in the manufacturing sector is reducing some of the pressures that had boosted prices from 1987 to early 1989.

The Household Sector

Total personal consumption expenditures were buffeted this winter by large swings in outlays for energy items and motor vehicles. Expenditures for home heating declined sharply in the first quarter as unseasonably warm temperatures in January and February followed a December that had been colder than usual. This influence was largely offset by a rise in motor vehicle sales. In late 1989 sales of cars and light trucks had been depressed by a scaling back of incentives and by large price increases for new model-year vehicles. Around the turn of the year, enriched incentive programs revived these sales. To date this year, sales of cars and light trucks have averaged 14 million units (annual rate)—a pace not far below the total for 1989—and seem largely to reflect replacement demand and growth in the driving age population.

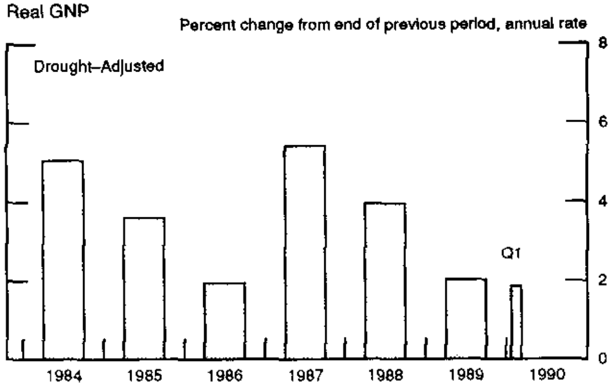
Abstracting from the swings in outlays on home heating and motor vehicles, consumption spending appears to have stagnated this spring after posting a moderate gain in the first quarter of 1990. The recent sluggishness in spending reflects declines in outlays for a wide variety of consumer goods, including furniture and other household durables. In contrast, spending for services other than energy, especially medical services, continues to outpace real income growth.

Growth of consumption has slowed this year against a backdrop of somewhat smaller gains in real disposable personal income. But consumption has slowed even more than income, and the personal saving rate rose above 6 percent in the spring. Consumers may be spending more cautiously as they reassess their income and wealth prospects in light of the slower growth of the economy and a softening of residential property values in many parts of the country. These factors probably have been particularly important in the Northeast, where consumer sentiment has deteriorated markedly. However, other indicators, such as delinquency rates on consumer loans, do not reveal broad pressure on household finances. Nor are there signs that credit availability has been reduced: Federal Reserve surveys of bank lending officers suggest no change in the willingness to lend to consumers.

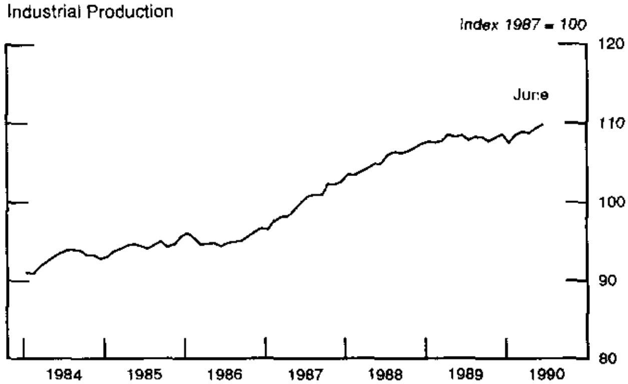
Residential investment spending also was affected by unusual weather patterns this winter. Housing starts were strong in the first two months of the year, as mild temperatures allowed builders to catch up on work delayed by cold weather in late 1989 and to begin projects that normally would have been started later in the year. Then starts slumped this spring, in part reflecting a "payback" for the winter activity. Averaging over this period, residential construction appears to have weakened; in the first five months of the year, housing starts totaled 1.36 million units (annual rate), somewhat below the pace of activity in 1989. By region, housing markets have been very weak in the Northeast, while homebuilding has been better maintained, albeit at moderate levels, in the North Central and Western regions of the country.

Both demand and supply factors have contributed to the recent weakness in housing construction. Sales of new and existing homes generally have been moving lower for more than a year; in part, demand may have been restrained by slower growth in income and reduced investment motivation for home purchase because of softening house prices. Demand also may

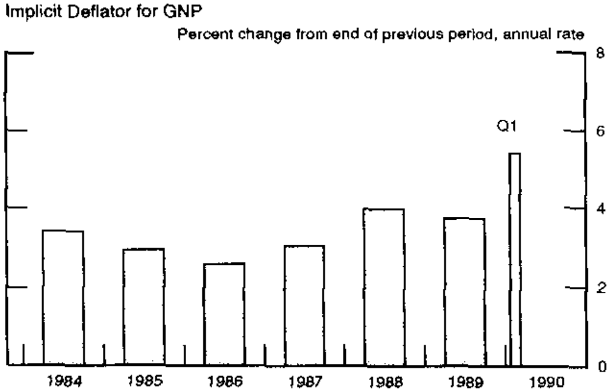
Real GNP



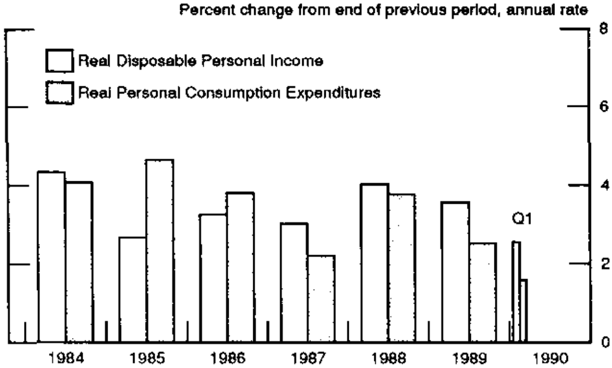
Industrial Production



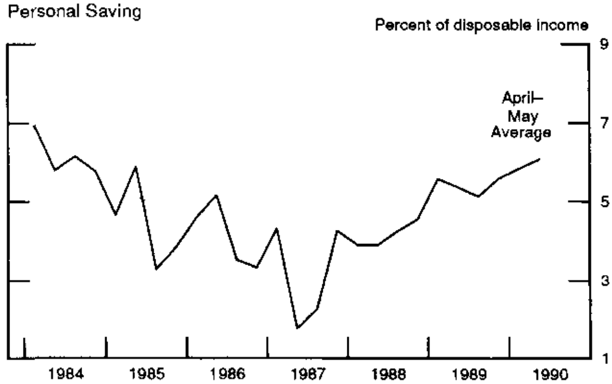
Implicit Deflator for GNP



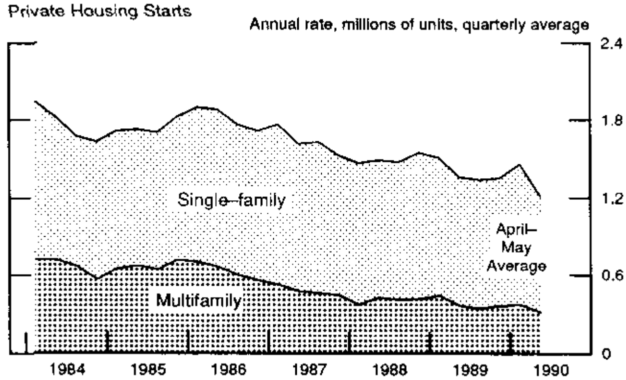
Real Income and Consumption



Personal Saving



Private Housing Starts



have been tempered this spring by some edging up in mortgage rates. Since early May, however, mortgage rates have moved down about ½ percentage point, and there is no evidence that access to home loans has been curtailed.

On the supply side, building is being deterred in some parts of the country by an overhang of unsold or unrented housing units. In addition, it appears that a reduction in credit availability for construction may be playing some role in damping building activity. To a degree, this less favorable credit climate is attributable to the cutback in financing supplied by thrift institutions owing to the closure of savings and loans as well as the more stringent capital requirements and lending limits mandated by the Financial Institutions Reform, Recovery, and Enforcement Act. At the same time, other institutions do not appear to be filling the void completely. In part, the shift in credit availability reflects the elimination of the imprudently aggressive lending that capsized so many thrift institutions. A number of commercial banks also have recently experienced reductions in their lending capacity as they have written off, or reserved against, bad loans. But, in addition, the number of sound lending opportunities undoubtedly has shrunk as a consequence of economic weakness and soft property values in specific locales.

The Business Sector

The financial position of the business sector deteriorated further during the early part of 1990. Before-tax profits from current operations of nonfinancial corporations edged down in the first quarter after falling nearly 18 percent over the four quarters of 1989. Profits have been squeezed by a combination of marked increases in wages and benefits during a period of weak growth in productivity, competitive pressures from both home and abroad that have prevented firms from completely passing increases in labor costs through to prices, and higher debt-servicing costs associated in part with increased leverage.

Shrinking profits, which have reduced the availability of internal funds, along with the slower growth of final sales and easing of capacity pressures over the past year, have muted the demand for new plant and equipment. Reflecting these developments, real business fixed investment has decelerated considerably since the first half of 1989.

Although total real spending on producers' durable equipment rose at an annual rate of about 7 percent in the first quarter, spending was boosted by a rebound in outlays for motor vehicles and a resurgence in aircraft shipments following the settlement of the strike last November at Boeing. Excluding these transitory swings, real equipment spending slowed further in the first quarter, and shipments of most types of capital goods – especially industrial machinery – remained soft in April and May. One bright spot in the equipment picture, however, has been the growth in outlays for computers and other information-processing equipment, after some slowing during the second half of 1989.

Nonresidential construction was boosted by favorable weather early in the year, but most of the gain has since been reversed. The weakness is most evident in office and commercial real estate, for which vacancy rates are high and data on contracts and permits suggest the outlook for building remains decidedly negative. In some areas, this reflects sluggish growth in the regional economies. However, activity also may be hindered by the shift in the credit climate, as more speculative projects that previously might have been financed no longer qualify. An exception to the weakness in business construction has been in the industrial sector; lead times can be quite long for these projects, however, and much of the continued strength undoubtedly reflects in large part decisions made when capacity pressures were mounting in 1988 and early 1989. Indeed, contracts and permits for new industrial construction have been trending down for about a year.

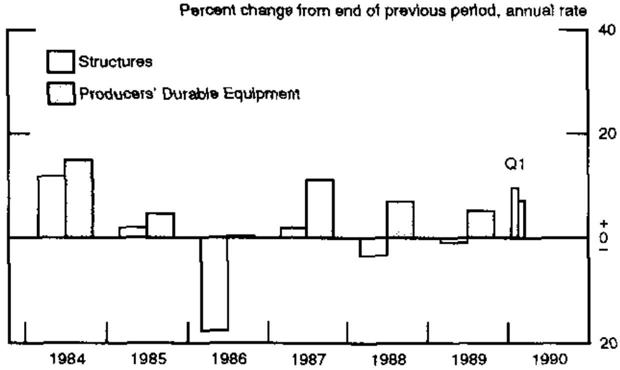
The emergence of uncomfortably high inventories in some sectors in late 1989 led to corrective actions in the first part of this year. Most prominently, manufacturers of motor vehicles cut production sharply and reinstated widespread sales incentives to eliminate an overhang of stocks on dealer lots. In most other sectors, stocks have been trimmed or have been increased only modestly this year, and they appear to be in good alignment with sales trends. Among the possible exceptions are wholesale distributors of machinery and nonauto retailers, where some mild overhangs appear to have developed this spring; these could precipitate further adjustments, probably affecting both domestic and foreign producers.

The Government Sector

The federal budget deficit over the first eight months of the fiscal year was $152 billion, up from $113 billion in the year earlier period. About $15 billion of this increase resulted from spending by the Resolution Trust Corporation, and further RTC outlays during June imply that the year-to-year increase in the deficit is likely to widen. Most of the RTC spending reflects financial transactions in which existing federal insurance obligations to thrift depositors are being recognized in the government's budget outlay and public

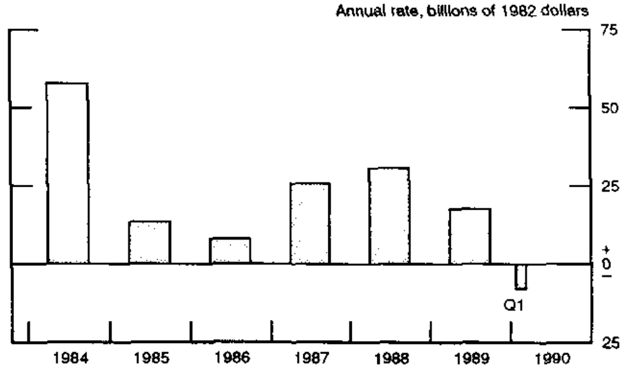
Real Business Fixed Investment

Percent change from end of previous period, annual rate



Changes in Real Nonfarm Business Inventories

Annual rate, billions of 1982 dollars



After–tax Profit Share of Gross Domestic Product *

Percent

Ratio of profits from domestic operations with inventory valuation and capital consumption adjustments to gross domestic product of nonfinancial corporate sector.

debt accounts. The RTC's borrowing and spending thus should have little effect on real economic activity or interest rates.

However, several other budget components have contributed to the higher deficit. Spending on Medicare and other health care programs, and some discretionary spending for the space and other programs, has surged. During the same period, revenue growth has lagged as weak corporate profits have cut into receipts and last year's surprisingly large personal income tax collections have not been sustained. The latter suggests that some of last year's receipts reflected special factors, such as the deferral of tax liabilities in response to the phased reduction of income tax rates under the Tax Reform Act of 1986, and the capital gains realized during sharp movements in financial markets.

Federal purchases of goods and services, the part of expenditures that is included directly in GNP, fell in real terms over 1988 and 1989, owing mainly to declines in defense spending. Real defense purchases continued to move lower in the first quarter of 1990; however, the downtrend in total purchases was interrupted by a pickup in nondefense spending, mainly a transitory surge in space expenditures. In the second quarter, compensation for temporary Census workers added to federal purchases.

Real state and local government purchases increased at an annual rate of 4¼ percent in the first quarter, compared with the 3 to 3½ percent pace recorded over the past three years. Revenue growth generally has not kept up with gains in spending, however, and an increasing number of state and local governments face significant budgetary difficulties; indeed, the overall deficit of the sector (excluding social insurance funds) was about $45 billion (annual rate) in the first quarter of 1990, almost $11 billion greater than the deficit recorded in the 1989 calendar year. These difficulties are compounded by growing spending requirements in several important areas. An increase in the number of school-age children has boosted public school enrollments, the number of medicaid recipients has increased, and prison populations have risen rapidly. Meanwhile, legislatures have been reluctant to increase personal income taxes, and federal grants and increases in state excise taxes have failed to prevent the widening of the gap between spending and revenues.

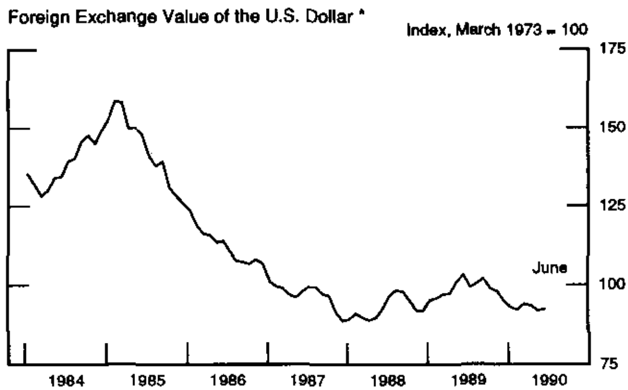
The External Sector

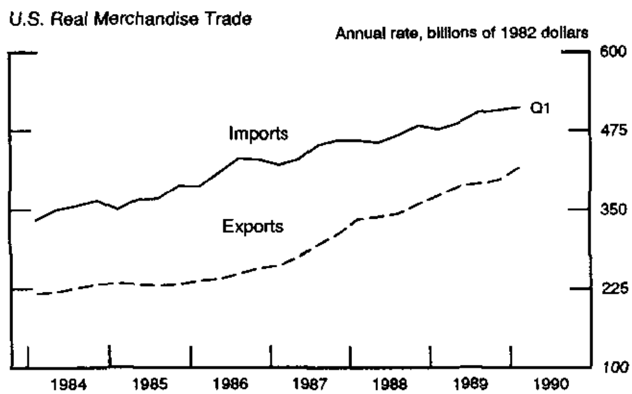
Movements in the exchange rate have been smaller than those in 1989, when the dollar appreciated about 12 percent in terms of the other G-10 currencies over the first half of the year and then depreciated by a similar amount between last summer and this past February. The dollar appreciated approximately 2 percent between February and March this year, but has since declined about 4 percent, partly in response to publication of weaker data on U.S. economic activity and the associated washing out of expected increases in interest rates.

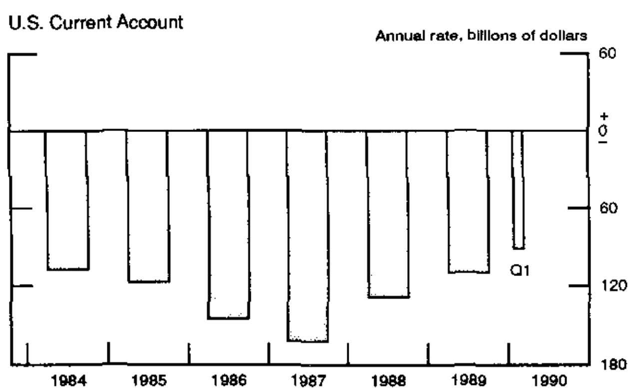
While the value of the dollar has not changed dramatically on a trade-weighted average basis against the other G-10 currencies this year, there have been some divergences in bilateral exchange rates. On balance, the dollar has depreciated significantly against sterling and the Swiss franc, and somewhat less against the German mark and related currencies. In contrast, the dollar has appreciated against the yen, despite exchange market intervention by the Bank of Japan and other central banks to support the value of the yen early in the year. Against the currencies of our other major trading partners in the Pacific Basin, the dollar has depreciated against the Singapore dollar, but appreciated in terms of the South Korean won and the new Taiwan dollar.

Prices of non-oil imports, which fell at about a 3 percent annual rate between the first and third quarters of last year, rose at a similar pace between the third quarter of 1989 and the first quarter of 1990, partly in response to the drop in the dollar between last summer and the early part of this year. Prices of imported oil surged around the turn of the year, moving above $20 per barrel in January, but since then they have more than retraced this runup. On the export side, prices rose at an annual rate of just 1¾ percent in the first quarter of 1990 after recording little change, on balance, over 1989 as a whole. In the first quarter, prices for agricultural exports fell somewhat, but there was an acceleration in prices for exported consumer and capital goods that appears to have been related to some pickup in prices for these items in domestic markets around the turn of the year.

Merchandise exports continue to provide an important impetus to growth in the domestic economy, although the increases in exports have slowed somewhat from the very rapid advances recorded in the latter part of the 1980s. So far this year, exports have been boosted by strong shipments of aircraft with the rebound in activity at Boeing, as well as by notable increases in other classes of machinery, agricultural products, industrial supplies, and consumer goods. Two factors have contributed to further large gains in the quantity of U.S. exports: Many of our major trading partners abroad have continued to register strong economic growth, and the average dollar prices of U.S. exports have declined somewhat relative to







* Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of other G-10 countries. Weights are 1972–76 global trade of each of the 10 countries.

average prices abroad. Movements in nominal exchange rates do not appear to have contributed significantly to either export growth or overall U.S. external adjustment in recent quarters; the effects of the large depreciation of the dollar through 1987 have waned, and any residual positive effects probably have been offset by the average strengthening of the dollar last year. However, the depreciation of the dollar since last summer should lend some stimulus to external adjustment in coming quarters.

Meanwhile, slower import growth has accompanied the slackening pace of activity in the United States. Total imports were boosted by a surge in oil imports in the first quarter, but, on balance, non-oil merchandise imports have edged down this year. The slowdown in imports has been pronounced in automotive products and consumer goods, reflecting both weaker domestic final demands and the inventory adjustments in these sectors of the U.S. economy.

Together, the continued growth in exports and the slowdown in imports narrowed the merchandise trade balance to $105 billion at an annual rate in the first quarter of 1990, its lowest rate since early 1985. The current account deficit was reduced to $92 billion at an annual rate.

Net private capital inflows, and a large statistical discrepancy, provided the counterpart to the current account deficit in the first quarter of 1990, as they did for 1989 as a whole. Most of the private capital inflow in the first quarter came through the banking sector. Private foreign investors continued to acquire U.S. corporate bonds in the first quarter; however, they sold a small amount of U.S. Treasury securities, and they continued to sell U.S. corporate stocks as they have since last October. Foreign direct investment flows into the United States slowed markedly in the first quarter to a rate well below that recorded in recent years. Official capital showed a net outflow in the first quarter, as it did throughout most of 1989, reflecting the net sale of dollars in exchange market intervention.

Labor Markets

Job growth was strong early in the year, but has softened recently. In January and February, increases in nonfarm payroll employment averaged more than 350,000, fueled by large increases in service-producing industries as well as by robust hiring in construction during the warmer than normal winter weather. Since March, however, job growth has averaged about 125,000 per month, despite the net addition of about 300,000 temporary workers to help carry out the 1990 Census; private payrolls have increased less than 20,000 per month. Manufacturing employment has continued to shrink this year at about the same rate as in the second half of 1989, and construction payrolls also have declined since the winter. Meanwhile, job growth in the service-producing industries has slowed in recent months. Although hiring gains have continued strong for health services, growth in jobs in business services has moderated, and there have been only small gains in employment at retail establishments.

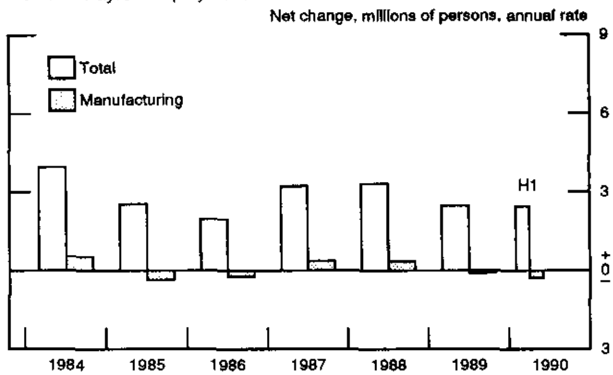
Growth in the labor force also has been subdued in recent months. To an extent, this reflects longer-run demographic trends; but it may also reflect a tendency for fewer people to seek jobs when the growth of employment opportunities is perceived to have slackened. Survey data suggest that individuals have increasingly viewed jobs as harder to find.

The slower rates of growth in employment and the labor force have been roughly matching, and the civilian unemployment rate has remained near 5¼ percent throughout the year. While unemployment rates have risen noticeably in the Northeast and moved up in some Midwestern states, jobless rates in other regions of the country either have changed little or have edged down.

With labor markets remaining relatively tight by historical standards, pressures on labor costs have not abated. Although the rate of increase in straight-time wages has changed little over the past year and a half, benefit costs, which currently constitute roughly one-fourth of compensation, have picked up markedly. In part, this increase reflected the higher social security taxes that went into effect in January, but benefits also have been boosted by the continued rise of health insurance costs and an acceleration of lump-sum payments and bonuses. All told, employee compensation in private nonfarm industry rose 5¼ percent over the twelve months ended in March, a bit above the pace recorded in the year ended last December.

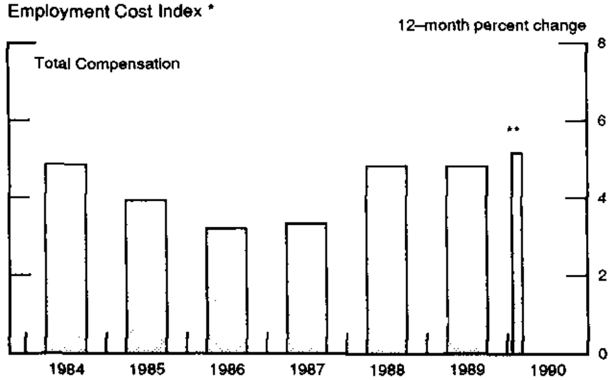
In addition to gains in hourly compensation, unit labor costs have been boosted by a poor performance in labor productivity, as output per hour in the nonfarm business sector rose just ¼ percent between the first quarter of 1989 and the first quarter of 1990. While productivity has remained strong in the manufacturing sector, rising almost 5 percent at an annual rate in the first quarter, productivity performance outside of manufacturing has been quite weak. As a consequence, unit labor costs in the first quarter of 1990 were 5 percent above their level a year earlier, about the same increase as recorded over 1989 as a whole, but well above the rates that prevailed earlier in the expansion.

Nonfarm Payroll Employment



Civilian Unemployment Rate

Employment Cost Index *



* Employment cost index for private industry, excluding farm and household workers.

** Percent change from Q1 1989 to Q1 1990.

Price Developments

After surging in the first quarter of 1990, price increases moderated this spring. Food and energy prices were boosted early in the year by weather-related developments, and prices for a wide range of other goods and services also picked up sharply. However, by May, the transitory effects of the weather on inflation largely had been reversed, and price increases for many other items slowed significantly.

Energy prices surged this past winter, as a result of demand pressures from the unseasonably cold weather in December and supply disruptions at U.S. refineries and in Eastern Europe. The posted price of West Texas Intermediate oil, the benchmark for U.S. crude prices, rose about $3 per barrel to a peak of $22 in January. Since early February, on balance, the posted price for WTI has moved down substantially, in large part reflecting the effects on crude markets of increased output by OPEC nations. Movements in energy prices at the consumer level normally follow developments in crude oil prices. Gasoline prices, however, remain higher than in December. In part, pump prices have been boosted by the additional costs to refiners of complying with environmental standards. In addition, inventories of gasoline were relatively low during the first half of the year as a result of a variety of supply disruptions at refineries.

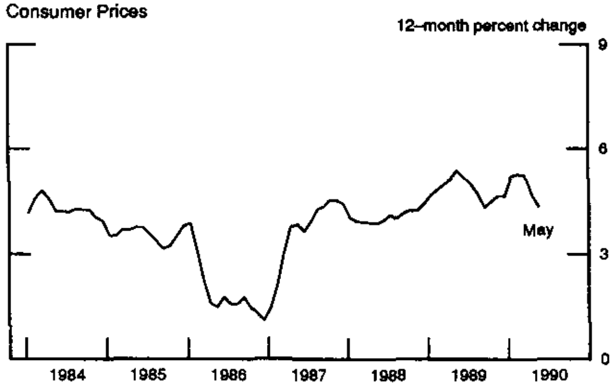
Overall, consumer food prices were boosted by sharp increases in prices for fresh fruits and vegetables after the freeze in December, but during the spring these prices retraced most of their earlier climb. The prices for other foods for home consumption have continued on an upward course. In addition, the prices of foods and beverages purchased at restaurants have risen at a 6 percent annual rate so far this year, about 1½ percentage points above the average rate of increase over the past two years; these prices probably have reflected a dwindling supply of entry-level workers and related increases in labor costs, and perhaps in some regions by the higher federal minimum wage.

The CPI excluding food and energy rose about 4¾ percent over the twelve months ending in May, near the upper end of the range experienced during the current expansion. Price increases for consumer goods, particularly apparel, rose sharply early in the year. However, the burst in prices did not carry through to the second quarter, as prices for commodities excluding food and energy changed little in April and May.

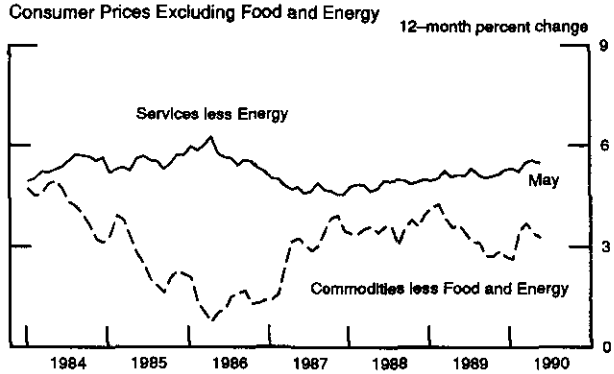
In the service sector, inflation rose markedly in the first quarter, in part reflecting some bunching of increases for items whose prices tend to change in irregular jumps, such as public transportation fares and auto registration fees. Although inflation in service prices moderated in the spring, there was little retracing of the earlier increases; indeed, in May, the CPI for nonenergy services was 5½ percent above its level twelve months earlier, the upper end of the range of increases seen over the past three and a half years. As in 1989, increases in prices of rents and medical services contributed importantly to the rise in overall service prices so far this year. However, there also have been widespread pickups in prices for a variety of labor-intensive services, and it is likely that, in addition to strong consumer demands, higher labor costs have boosted service prices.

The signs of moderating inflation for goods at earlier stages of processing, which had surfaced as capacity utilization rates moved down during 1989, appear to have continued into 1990. After rising 4¼ percent in 1989, the PPI for finished goods excluding food and energy has increased at an annual rate of about 3¾ percent during the first six months of 1990. Producer prices for intermediate materials excluding food and energy increased at an annual rate of just ¾ percent between December and June, roughly the same rate of increase as recorded over 1989 as a whole. The moderation of inflation for goods at the producer level is perhaps one indication that earlier moves toward monetary restraint and the slower pace of economic activity have worked to ease the resource constraints that had pushed up materials prices between 1987 and early 1989.

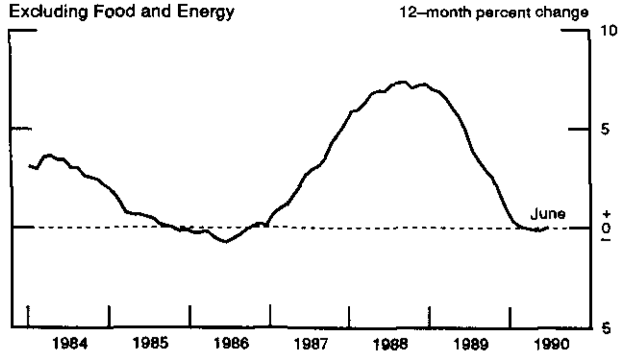
Consumer Prices



Consumer Prices Excluding Food and Energy



Producer Prices for Intermediate Materials
Excluding Food and Energy



Section 3: Monetary and Financial Developments During the First Half of 1990

Shifts in financial intermediation and credit flows, stemming from the continued restructuring of the thrift industry and a more cautious attitude of banks toward certain credit extensions, exerted a major influence on the monetary aggregates and their relation to economic activity during the first half of 1990. In anticipation of further contraction in the thrift industry, and its associated effects on depository intermediation, the Committee reduced the annual growth range for M3 by a full percentage point in February. In the event, M3 has slowed even more dramatically than had been anticipated, leaving this aggregate below the lower bound of its reduced range. Not only has the thrift industry contracted more rapidly than expected, but commercial banks have picked up little of the lending forgone by thrifts and, in fact, have curtailed their own lending in some sectors, thus further depressing depository credit. With little need to fund asset growth, banks and thrifts have pursued retail deposits less aggressively, leading to the opening of a sizable gap between yields available in the open market and those on such deposits. Partly as a result, M2 also has slowed, moving down into the lower portion of its annual growth range.

The deceleration of the monetary aggregates mainly reflects a reduction in the share of credit provided by depositories, rather than a sharp slowing of income or total credit flows. The velocities of both M2 and M3 posted sizable increases, particularly in the second quarter. Total debt of domestic nonfinancial sectors grew at an annual rate of 7 percent over the first half of the year—down only slightly from its pace in the latter half of 1989 and in the middle of its monitoring range. However, growth of total debt was boosted by federal government borrowing to support thrift resolutions; the debt of nonfederal sectors grew somewhat less rapidly than it did last year. Uncertainty about the effects of the restructuring of credit flows, and about the reasons for the extent of the slowdown in money growth, underlined the need for the FOMC to assess the behavior of the aggregates in light of information on spending and prices and the likely course of monetary velocities.

The somewhat more cautious lending posture that commercial banks have recently adopted is mainly a response to heightened credit risks caused by the more moderate pace of economic expansion overall and a downturn in several sectors. The resulting loan write-offs and pressures on capital positions may also have induced some tightening of standards. Growing markets for securitized loans largely have filled the vacuum created by the retrenchment of thrifts in the area of mortgage lending, with little attendant effect on the cost or availability of residential mortgage credit to households. Both banks and thrifts have cut back on other types of lending that can less easily be rechannelled, however, including construction and nonresidential real estate loans, loans to highly leveraged borrowers, and loans to small and medium-sized businesses. To offset tighter credit market conditions, which could exert undue restraint on aggregate demand, the Federal Reserve has recently adopted a slightly more accommodative stance with regard to reserve provision, fostering a small decline in market interest rates.

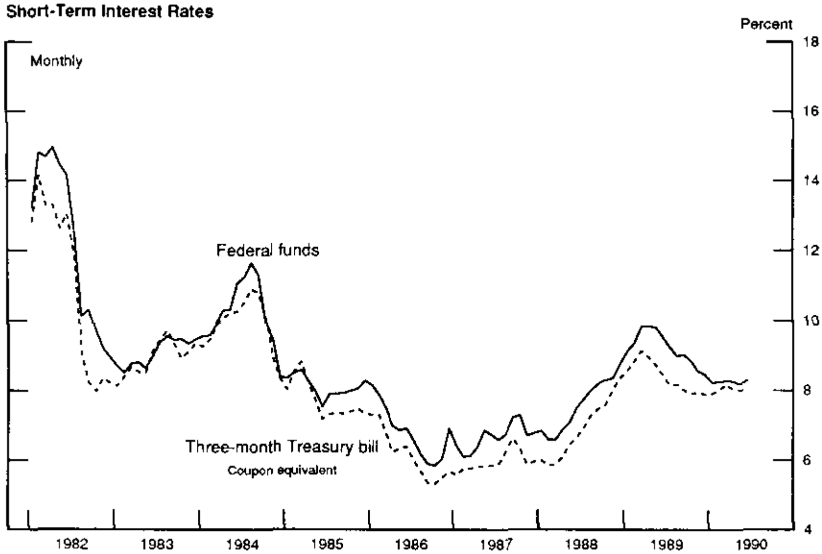
The Implementation of Monetary Policy

The FOMC maintained a steady degree of pressure in reserve markets during the first six months of the year. Policy had been eased in the second half of 1989 amid concerns that the economic slowdown might cumulate and thereby threaten the expansion. In the first half of 1990, however, the Committee viewed the balance of evidence as suggesting that underlying trends were generally consistent with its objectives of sustaining economic growth while containing and eventually reducing inflationary pressures.

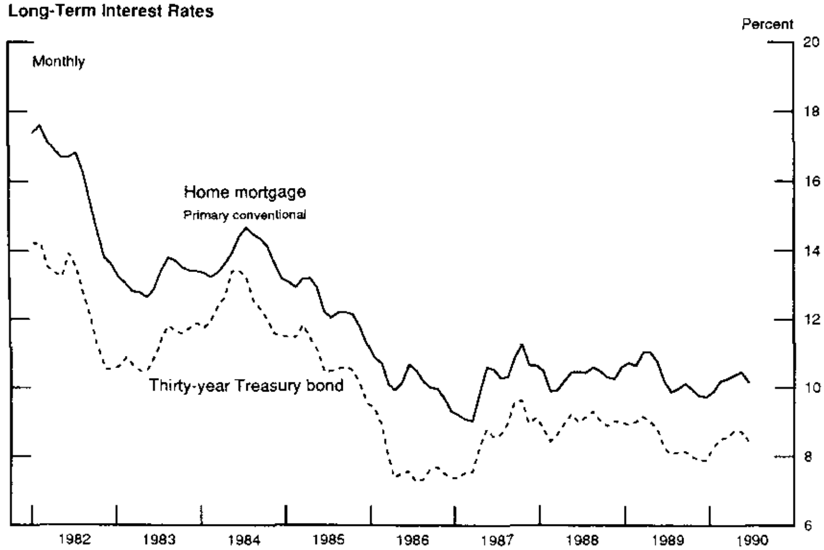
In the opening months of the year, incoming information on spending and prices caused markets to reevaluate the prospects for a near-term reduction of inflationary pressures and further easing of monetary policy. As a result, market interest rates rose, despite a steady federal funds rate. The rise was most pronounced at the longer end of the maturity spectrum, and it restored the usual upward tilt to the yield curve that had been absent much of last year. Developments in Eastern Europe, which portended increases in demands on the world's limited pool of savings, also contributed to increases in long-term rates in the United States and abroad. By late April, market participants expected a near-term tightening of U.S. monetary policy.

In early May, the pendulum of market opinion began to swing away from the view that a tightening of U.S. monetary policy was in the offing. Beginning with a lackluster employment report on May 4, economic data have pointed to a somewhat slower pace of activity and reduced price pressures. In addition, a pronounced slowdown in the monetary aggregates began in April, followed by outright declines in May. Although both M2 and M3 recovered a little in June, they remained below the midpoint and the lower bound, respectively,

Short-Term Interest Rates



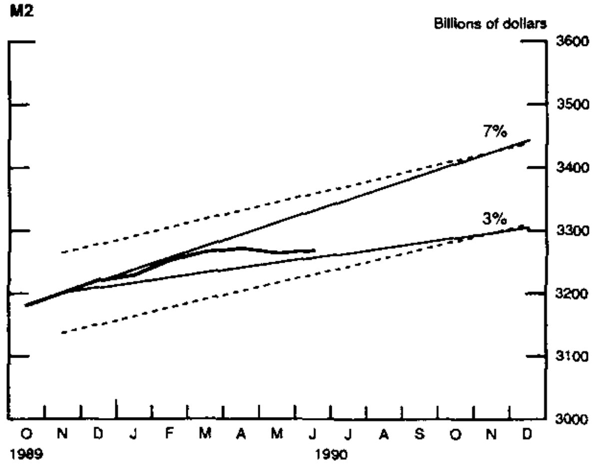
Long-Term Interest Rates



Observations are monthly averages of daily data; last observation for June, 1990.

M2 and M3: Target Ranges Adopted in February and Actual Growth

M2

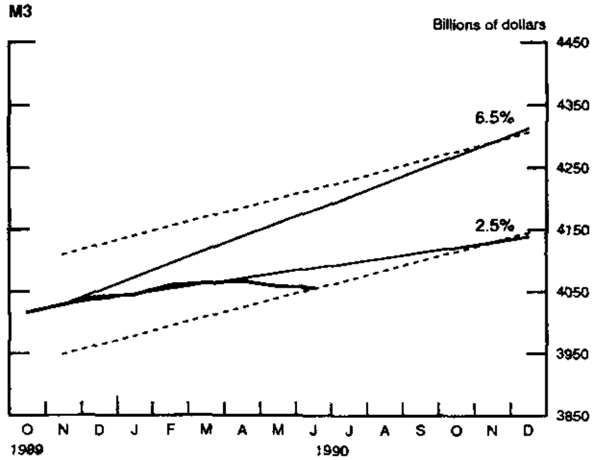


Rate of growth

Q4 1989 to Q2 1990
4.2 percent

Q4 1989 to June
3.6 percent

M3



Rate of growth

Q4 1989 to Q2 1990
1.6 percent

Q4 1989 to June
1.2 percent

of their annual ranges at midyear. Evidence also suggested that restricted credit availability, in part the result of tightened credit standards, may have spread beyond commercial real estate, construction, and merger-related lending. In response to this firming of credit conditions, the Federal Reserve began providing reserves slightly more generously through open market operations in mid-July.

Market interest rates, which already had receded somewhat from their early spring highs, declined further with the Federal Reserve's recent easing, though intermediate and long-term rates remained above the levels seen last December. Lower interest rates also bolstered the stock market, and some share price indexes reached record highs this month.

Spreads between high-quality private instruments and Treasury issues narrowed slightly over the first half of 1989. This narrowing reflected the continued availability of funds for investment-grade borrowing as well as increases in the borrowing needs of the RTC, which are met partly through the Treasury. The pickup in Treasury borrowing for the RTC was necessitated by the faster pace of thrift resolutions, which require the government to carry thrift assets on its own balance sheet pending their disposition. The market for investment-grade issues continued to function reasonably well, with stable rate spreads between quality tiers and generally well-maintained issuance volumes. On average, however, the business sector faced somewhat higher borrowing costs, largely as the result of numerous downgradings of debt issues. The collapse of Drexel Burnham Lambert had a marginal impact on an already debilitated market for below-investment-grade issues, widening spreads somewhat more between yields on such bonds and those on other long-term securities.

Monetary and Credit Flows

Growth of the monetary aggregates was sluggish over the first half of 1990, with M2 and M3 expanding at annual rates of only 3½ percent and 1¼ percent, respectively, from the fourth quarter of 1989 through June. The weakness in money growth primarily reflected a redirection of credit extensions away from depository institutions owing to the continued downsizing of the thrift industry and a more cautious lending posture of commercial banks.

The deceleration of M2 growth did not begin until the second quarter of 1990, when growth slowed to a 2¼ percent annual rate from the 6 to 7 percent range seen in the previous three quarters. Retail deposits (which include NOW accounts as well as savings, small time deposits, and similar instruments) had begun to decelerate in the first quarter, slowing to a pace of less than 4 percent from the 5¾ percent rate seen in the fourth quarter of 1989. The effects of this slowdown on M2 were partially masked, however, by a surge in currency growth—apparently owing in part to increased demand from overseas—and a bulge in some of M2's wholesale components, mainly overnight RPs and Eurodollars. By the second quarter, a steep runoff in retail money market mutual fund (MMMF) shares and a sharp decline in demand deposits reinforced weakness in core deposits in damping growth in aggregate M2.

Increases in the opportunity costs of holding M2 balances—that is, the rise in other interest rates relative to those on M2—retarded growth in this aggregate during the first half of the year. This was particularly evident for retail MMMFs. Through much of 1989, the yield curve was inverted, and MMMFs, whose portfolios typically average about 30 to 40 days in maturity, had historically large yield advantages relative to longer-term Treasury bills and short-dated Treasury notes. As a result, MMMFs expanded briskly. As the yield curve began to flatten towards year-end, flows into MMMFs ebbed, though they remained a key element of overall M2 growth. With the steepening of the yield curve in the early part of 1990, MMMF growth stopped in March. The recent rally in the stock market also may have depressed MMMFs, as data through May indicate strong inflows to equity mutual funds, a substantial portion of which may have been transferred from MMMFs.

When yield curves have become more steeply upward sloping in the past, the effect on M2 of weakness in MMMFs and other liquid balances often has been partially offset by strength in retail time deposits, as households lengthen the maturity of their assets. This year, however, retail CD rates were unusually slow to respond to the rise in market rates through April, contributing to unexpected weakness in M2. The reluctance of banks to raise deposit rates in response to rising market rates was particularly evident in the intermediate-term area where, for example, the rise of 100 basis points in the yield on the three-year Treasury note during the first four months of the year elicited an increase of less than 20 basis points in rates on bank retail CDs of comparable maturity. Evidence of the rising opportunity cost of holding M2 can be seen in the unusually heavy volume of noncompetitive tenders in Treasury bill and note auctions, which suggest a shift out of M2 balances.

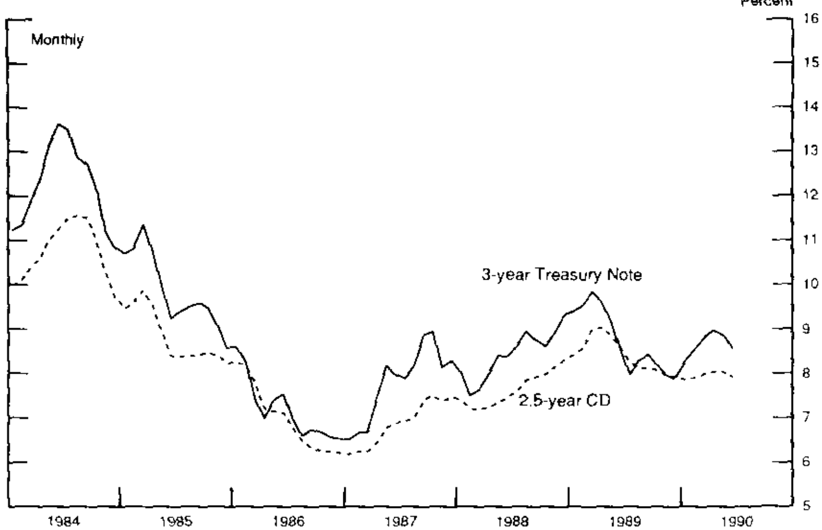
The unwillingness of banks to price their deposits as aggressively as in the past is partly an indirect result of the contraction of the thrift industry. During the

Growth of Money and Debt *(Percentage change)*

		M1	M2	M3	Debt of domestic nonfinancial sectors
Fourth quarter to fourth quarter					
1980		7.4	8.9	9.5	9.5
1981		5.4 (2.5)*	9.3	12.3	10.2
1982		8.8	9.1	9.9	9.1
1983		10.4	12.2	9.8	11.2
1984		5.4	7.9	10.6	14.2
1985		12.0	8.9	7.8	13.1
1986		15.5	9.3	9.1	13.2
1987		6.3	4.3	5.8	9.9
1988		4.3	5.2	6.3	9.1
1989		0.6	4.5	3.3	8.1
Quarterly (annual rate)					
1990	Q1	4.8	6.0	2.7	6.9
	Q2	3.6	2.3	0.4	7.0[e]
Semiannually (annual rate)					
1990	H1	4.2	4.2	1.6	7.0

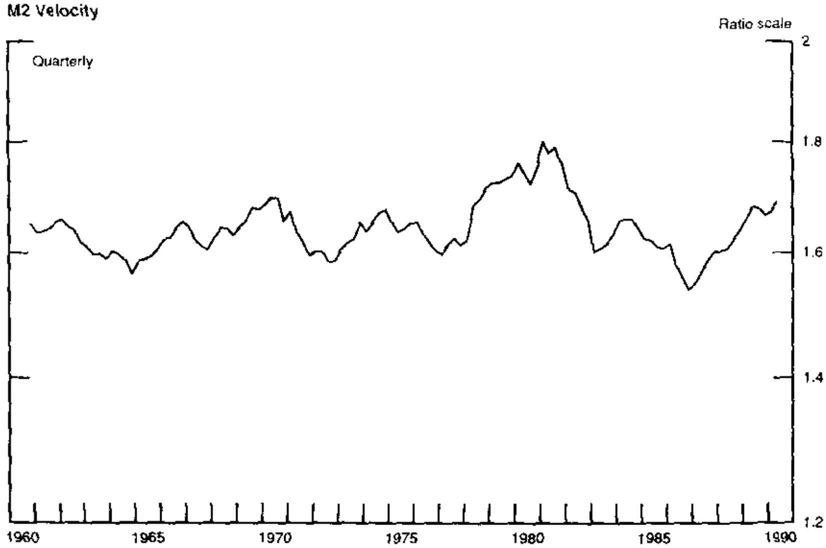
*Figure in parentheses is adjusted for shifts to NOW accounts in 1981.
e - estimated

3-year Treasury Note and 2.5-year Commercial Bank CD Rates



NOTE: Rates taken on coupon-equivalent, 365-day basis.
Preliminary data for June, 1990 CD rate.

M2 Velocity



NOTE: M2 Q2 1990 velocity based on projected GNP for Q2 1990.

first six months of 1990, commercial banks enjoyed $62 billion in retail deposit inflows—about a 10 percent increase at an annual rate—while thrifts were shedding $28 billion in retail deposits—about a 5 percent annual rate of contraction. Much of this deflection of deposits toward commercial banks was the direct result of RTC resolutions. In the first half of the year, the RTC resolved 170 thrifts holding $32 billion of non-brokered retail deposits, much of which was immediately assumed by commercial banks.

Although deposit transfers do not directly depress M2, they may have contributed to the weakness in this aggregate by reducing banks' need to raise their offering rates to attract additional deposits at a time when growth in bank credit was slow. Through the first half of 1990, commercial banks were able to fund nearly 80 percent of their total credit growth with retail deposits—almost double the proportion seen in recent years—even though they allowed spreads between market rates and their retail offering rates to widen substantially.

Widening opportunity costs of holding M2 can explain only some of the moderation in this aggregate in the first half of 1990, however. M2 may also have been responding to slower spending, and other factors, some of which may have been associated with deposit restructuring under the RTC. Brokered deposits formerly attracted to thrifts by relatively high yields may have been particularly sensitive to the recent sluggishness in deposit pricing; about $7 billion of brokered deposits were held at thrifts that were resolved in the first six months of the year, and many of these high- rate contracts were subsequently abrogated or not rolled over by the acquiring institutions. Evidence also suggests that, in light of large deposit inflows from thrifts, banks have curtailed marketing and promotional activity designed to attract retail deposits. Finally, the issuance of short-term Treasury paper to fund RTC holdings of former thrift assets has boosted the supply of, and raised the rates on, a close M2 substitute just when depositories were becoming less aggressive in seeking retail deposits. The rise in opportunity costs and these other factors contributed to an increase in the velocity of M2 in the first half of 1990, though some of this increase remains difficult to explain.

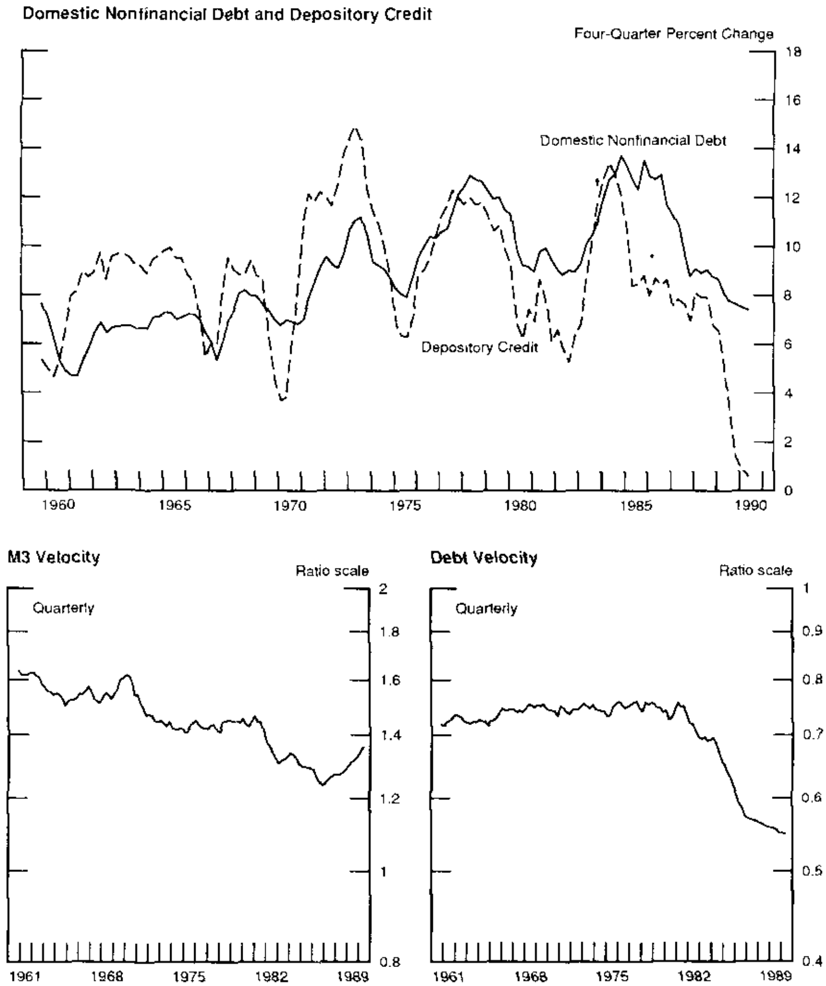
The link between changes in depository intermediation and M3 is somewhat more direct. This aggregate encompasses managed liabilities, as well as deposits and other sources of funds in M2, and is thus a better barometer of the overall funding needs of banks and thrifts. As has been evident since last summer, the contraction of the thrift industry and the failure of banks fully to pick up the slack has already resulted in a significant slowdown in growth of depository credit relative to that of aggregate nonfinancial sector debt and a concomitant increase in M3 velocity. This trend continued into the first half of 1990, as growth in depository credit all but ceased—though overall debt growth continued at a moderate pace—and M3 fell well below the lower bound of its annual growth cone.

Although the FOMC foresaw some significant damping effects on M3 growth in 1990 in association with the continued shrinkage of the thrift industry, the actual weakness in M3 so far this year has been more pronounced than anticipated. In setting out its expectations for M3 in 1990, the Committee recognized that considerable uncertainties surrounded the thrift industry contraction in terms of the pace of RTC resolutions, the extent of asset shrinkage at capital-impaired thrifts, and the desire of commercial banks to step into the breach. To this point, a faster-than-expected shrinkage of thrift assets has been manifested not only in weaker M2 deposit inflows, but also in faster runoffs of large time deposits and other M3 managed liabilities at thrifts. In addition, commercial banks apparently have filled less of the void left by thrifts than was originally anticipated. As a result, they too have pared their M3 managed liabilities, further depressing this aggregate.

Rates on large time deposits, like those on retail deposits, have remained low relative to yields on Treasury bills. Facing a substantial deterioration in the quality of their assets and constraints on capital, banks apparently have attempted to bolster profit margins and have not aggressively pursued new lending opportunities. Not only have deposit rates been held down, but loan rates also appear to have been raised slightly relative to market rates and non-price terms have tightened for certain types of credits.

The pullback in credit supplies, together with some levelling out of demands for credit, likely contributed to a deceleration of bank asset growth. Over the second quarter, growth of bank credit slowed to a 5¾ percent pace from the near 7 percent rate of growth seen over the first quarter of 1990 and the second half of 1989, with much of the deceleration centered in real estate and consumer lending. Although the slowdown in real estate lending has been especially pronounced in New England, this type of lending remains sluggish in several other regions as well. Some of the deceleration in consumer lending represents sales of loans by banks attempting to bolster capital-asset ratios. Even adjusted for these sales, however, growth of consumer loans at banks slowed further in the second quarter from an already reduced first-quarter pace. The weakness in consumer borrowing this year is due primarily

Weakness in Depository Credit



NOTES. Q2 1990 velocities based on projected GNP for Q2 1990. Debt for Q2 1990 partially estimated.

to sluggish retail sales, particularly of automobiles and other durable goods; banks evidently have remained willing lenders to households, and interest rates on consumer loans have changed little.

Bank lending to businesses also has been depressed this year. Surveys of commercial bank lending officers through early May suggest that the slowdown in bank credit largely reflects diminished demand for credit and deteriorating conditions in the real estate market, although tighter lending terms and more stringent credit standards were frequently cited for borrowers below investment grade, including many small businesses. Banks seem to have raised lending rates somewhat to small firms, judging from the slight increase in the spread between rates on small business loans and on federal funds. Separate surveys in which small businesses were queried about general credit availability have pointed to some recent increases in the difficulty these firms face in obtaining credit, though on balance they found credit availability little changed from mid-1989. The slowdown in bank business lending this year has mainly reflected reduced merger activity. Bank retrenchment in this area is consistent with other private credit judgments, as evidenced by the major slump in the market for bonds below investment grade.

The reduced volume of corporate restructurings, coupled with a diminished household demand for credit, has slowed the growth of the aggregate debt of domestic nonfinancial sectors to a 7 percent annual rate from the fourth quarter of 1989 through May of this year, compared with the 8 percent rate seen last year. Debt growth is currently in the middle of its monitoring range and broadly consistent with growth in nominal GNP. With the increasing leverage and the attendant dramatic declines in debt velocity witnessed in the 1980s apparently ending, the Committee reduced the 1990 monitoring range for debt by 1½ percentage points in February.

Debt growth decelerated in the first half of the year despite a spike in U.S. government borrowing, which owed primarily to the growing working capital needs of the RTC. RTC spending, net of capital raised off-budget by the Resolution Funding Corporation, jumped to $31 billion in the second quarter, up from the $4 to $5 billion levels of the previous two quarters. This spending is financed through the Treasury and is therefore included in the debt aggregate.

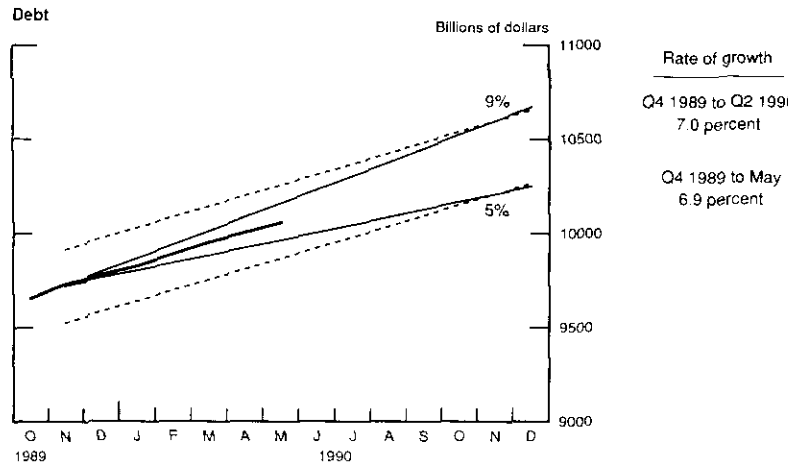
The pace of household borrowing slowed considerably in the first six months of 1990, reflecting decelerations in both mortgage and consumer credit. The recent slowing of home mortgage borrowing appears to be largely the result of reduced demand, owing to increases in interest rates earlier in the year and weakening economic activity in some regions of the country. Although banks have picked up only some of the slack for thrifts in the area of mortgage lending, the expanding market for securitized mortgages has facilitated an orderly flow of mortgage credit. In fact, spreads of mortgage-backed securities over comparable Treasury issues remain low by historical standards and rates on home loans have not risen noticeably relative to other long-term rates.

Consistent with households' sluggish spending, overall consumer installment credit has risen at a 2¾ percent rate from the fourth quarter of 1989 through May of this year, well below the 5½ percent clip in 1989. Some of this deceleration reflects substitution of home equity loans for previously existing consumer indebtedness; households apparently continue to recognize the lower relative after-tax cost of mortgage debt since the 1986 tax reform, which phased out the interest deductibility of non-mortgage household indebtedness. The slowdown in consumer loans on the books of depositories has been even more pronounced, reflecting a marked pickup in securitizations. The trend toward securitization of consumer loans, which has been evident in the last few years, appears to have accelerated in 1990, possibly because depositories are making efforts to reduce assets in order to meet the new risk-based capital requirements.

Through the first half of the year, the total borrowing of nonfinancial firms has been maintained at about the same pace as in the last half of 1989 despite a sharp drop in equity retirements. Although business lending by banks has slowed, commercial paper issuance picked up the slack, particularly in the first few months of the year. More recently, in light of declines in bond yields, firms have stepped up their issuance of bonds and slowed their use of commercial paper. Despite a recent slight narrowing of spreads relative to investment-grade securities, issuance of below-investment-grade bonds has remained in the doldrums. Spreads between investment-grade paper and Treasury issues are still low by historical standards, held down in part by supply pressures in the Treasury market.

In the municipal market, the increase in market interest rates and the downgradings of a number of key issuers during the first half of 1990 combined to slow refunding issuance to a crawl. As a result, the total debt of state and local governments expanded at only an annual rate of 3 percent in the second quarter, compared with 4½ percent in 1989.

Debt: Monitoring Range Adopted in February and Actual Growth



M1: Actual Growth