

# CONDUCT OF MONETARY POLICY

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

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## HEARING

BEFORE THE  
SUBCOMMITTEE ON  
DOMESTIC MONETARY POLICY  
OF THE  
COMMITTEE ON BANKING, FINANCE AND  
URBAN AFFAIRS  
HOUSE OF REPRESENTATIVES  
ONE HUNDRED SECOND CONGRESS

SECOND SESSION

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JULY 22, 1992  
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# FEDERAL RESERVE REPORT TO CONGRESS ON MONETARY POLICY

WEDNESDAY, JULY 22, 1992

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

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Stephen L. Neal [chairman of the subcommittee] presiding.

Present: Chairman Stephen L. Neal, Representatives Neal of Massachusetts, and Roth.

Chairman NEAL. I would like to call this meeting of the subcommittee to order. We meet this morning to welcome Chairman Greenspan for the presentation of the Federal Reserve's semiannual monetary policy report to Congress.

I would like to begin by congratulating the Chairman for the moderate and cautious approach the Fed seems to have taken on monetary policy so far this year.

It has faced, and continues to face, sharply conflicting pressures. On one side it confronts a growing chorus of demands for ever greater monetary stimulus, and ever sharper decreases in the Fed Funds Rate. On the other, it finds a persistent skepticism in the financial markets on the long-term outlook for inflation, and an unwillingness to bid down long rates in line with the Fed induced fall in short rates.

Though the Fed's cautious easing so far this year seems appropriate, the Chairman's testimony this morning offers two convincing reasons to believe the Fed has reached the limit of acceptable monetary stimulus. He states, in effect, that the current weakness in the broad monetary aggregates does not signal similar weakness in future economic growth. In other words, monetary policy does not need to boost M2 growth significantly in order to promote health economic recovery. Robust economic growth is not being hampered by a shortage of money or, more broadly stated, by insufficient financial liquidity.

Robust growth is, however, being hampered by balance sheet restructuring, as the Chairman uses that term, throughout the economy. Spending units of all kinds, households and businesses, are attempting to reduce outstanding debt. In the process, they spend and invest less out of a given income or cash-flow than they normally would. That inhibits economic growth.

If, as the Chairman also indicates, the financial markets are not yet prepared to reduce long rates very much in response to monetary ease, it should be evident that aggressive easing beyond this point can contribute little or nothing to the necessary rebuilding of healthier balance sheets. We must simply let that process run its course, and take care not to endanger, in the interim, the progress the Fed is making toward zero inflation or, as they call it, price stability. Nothing would be more useful for the economy than for the financial markets to become convinced that inflation will decline, not just over the next 2 years, but will stay down over the next decades. Then long rates would fall sharply, economic growth would surge, debt could be more easily retired, or refinanced at better terms.

The Fed cannot bring this about by aggressive easing. In fact, it can do nothing to bring it about by itself other than continue doggedly on a course that will eventually wring inflation out of the economy despite what the markets expect. It needs help from the political system in the form of serious support for a long-term commitment to price stability instead of constant and misguided carping for aggressive voluntary ease. This incessant pressure for ease is often justified by the argument that inflation is no longer a problem, that it is somehow under control. That is, unfortunately, far from true. Measured inflation has fallen a little, and may fall a little more in the near future.

The problem, however, is that inflationary expectations over time horizons that really count for investment and savings decisions—10 to 20 years, for example—remain excessively high. We will not have inflation under control, we will not enjoy lower long-term interest rates, we will not begin to reap the benefits of price stability until the Fed breaks the back of inflationary expectations. It has not yet done that, so inflation is not yet under control. If it was, then long rates would be low. Getting it under control, breaking the grip of high inflationary expectations on long-term interest rates must remain the foremost priority of monetary policy.

Before recognizing the Chairman, I would like to yield to our distinguished ranking minority Member, Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman.

I want to thank you for your temperate remarks this morning. After the display yesterday in the Senate, I wasn't expecting that, but it again shows that you are a man that is even-tempered, and one that is, I figure, more rational.

Mr. Chairman, my grandfather had a favorite word, it was the old word "chutzpah," and yesterday, when I saw you before the Senate, I said to myself, "Greenspan must be thinking, boy, these guys have a lot of chutzpah. Here they create the problem, and they come and dump on me."

Of course, you are too much of a gentleman to say that, so I thought I would say it.

We have, in our country, a \$4.3 trillion national debt, and that has to be reckoned with, and I just couldn't understand yesterday, when these Democrats were so anxious to kick Bush in the shins again while they talk about the deficit, my God, the House has been ruled by the Democrat Party now for 38 continuous years.

The last time the Republicans were in power Patti Page was singing "My Little Doggie in the Window."

Now, for 38 years, every chairman, every subcommittee chairman, every Speaker has been Democrat, and now they are still running around saying, "Hey, we have to point the finger at somebody," and so they are pointing at the Fed.

I would say that as far as getting interest rates down, you can't get them much lower than they are today. As far as getting inflation down, inflation is not the problem today. There is only one problem, and that is the Federal spending here in Congress, and that is why we have to ask a question, "Who killed the balanced budget amendment?"

It was the Democrat leadership in the House. Whose responsibility is it to balance this budget. It is us right here when we go over and vote.

I am delighted to see the Chairman of the Fed before us, a man we all recognize as one of the great minds in America today when it comes to our economy.

Mr. Chairman, I want to again thank you for your temperate remarks this morning.

Thank you very much.

Chairman NEAL. Thank you very much. I always enjoy my friend's comments, but I usually find myself in just the slightest disagreement with some of his analysis. Again, to set the record straight, it's during the last two administrations that we have quadrupled the national debt. We have done it because the administrations have essentially gotten what they wanted from the Congress.

You are correct; ultimately it is fiscal policy that is the problem. But I'd say to my friend, if we are going to solve our fiscal problems, we're going to have to work together and each side must give a little instead of spending so much time blaming. If we would solve our problems as well as the Fed is dealing with its today, we would be in pretty good shape.

I thank my friend for being here, and I welcome the Chairman. We will put your entire statement in the record, Mr. Chairman, and ask you to proceed as you will.

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

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

I am pleased to have the opportunity to present the Board's semiannual report on monetary policy to the Congress. Earlier this month, when the Federal Open Market Committee formulated its plans and objectives for the next 1½ years, it did so against the backdrop of an economy still working its way through serious structural imbalances that have inhibited the pace of economic expansion. In light of the resulting sluggishness in the economy and of persistent weakness in credit and money, the System on July 2 cut the discount rate by one-half percentage point and eased reserve market conditions commensurately. These actions followed a reduction in the Federal funds rate in early April. The recent eas-

ings of reserve conditions should help to shore up the economy, and coming in the context of a solid trend toward lower inflation, have contributed to laying a foundation for a sustained expansion of the American economy.

Our recent policy moves were just the latest in a series of 23 separate easing steps, beginning more than 3 years ago. In total, short-term market interest rates have been reduced by two-thirds. The Federal funds rate, for example, has declined from almost 10 percent in mid-1989 to 3¼ percent today. The discount rate has been cut to 3 percent—a 29-year low.

Despite the cumulative size of these steps, the economic recovery to date nonetheless has been very hesitant. Based on experience over the past three or four decades, most forecasters would have predicted that a reduction of the magnitude seen in short-term interest rates, nominal and real, during the past 3 years would by now have been associated with a far more robust economic expansion.

Clearly, the structural imbalances in the economy have proven more severe and more enduring than many had previously thought. The economy still is recuperating from past excesses involving a generalized overreliance on debt to finance asset accumulation. Many of these activities were based largely on inflated expectations of future asset prices and income growth. In short, an overbuilding and overbuying of certain capital and consumer goods was made possible by overleverage. And when realities inevitably fell short of expectations, businesses and individuals left with debt-burdened balance sheets diverted cash-flows to debt repayment at the expense of spending, while lenders turned considerably more cautious.

This phenomenon is not unique to the United States. To a greater or lesser extent, similar adjustments have gripped Japan, Canada, Australia, the United Kingdom, and a number of northern European countries. For the first time in a half century or more, several industrial countries have been confronted at roughly the same time with asset-price deflation and the inevitable consequences. Despite widespread problems, we seem to have at least avoided the crises that historically have been associated with such periods in the past.

In the United States especially, important economic dynamics ensued as the speculative acquisition of physical assets financed by debt outpaced fundamental demands. In some markets for physical assets, such as office buildings, a severe oversupply emerged and prices plummeted. In others, such as residential housing, average price appreciation unexpectedly came to a virtual standstill, and prices fell substantially in some regions. Firms that had been subject to leveraged buyouts based on overly optimistic assumptions about the future values at which assets could be sold began to encounter debt servicing problems.

More generally, disappointing earnings and downward adjustment in the values of assets brought about reduced net worth positions and worsened debt-repayment burdens. Creditors naturally pulled back from making risky loans and investments, and as pressures mounted on lenders' earnings and capital, some features of a so-called credit crunch appeared. With borrowers themselves be-

coming more cautious about taking on more debt, as well as about spending, credit flows to non-Federal sectors diminished appreciably.

It is not that this process was unforeseeable in the latter years of the 1980's. The sharp increase in debt and the unprecedented liquidation of corporate equity clearly were unsustainable and would eventually require a period of adjustment. What was unclear was the point at which financial problems would begin to constrain spending and how strong those constraints would be. Forecasts of difficulties with debt and strained balance sheets had surfaced from time to time over the past decade. But only in recent years did it become apparent that debt leverage had reached its limits, inducing consumers and businesses to retrench. Moreover, the degree of retrenchment has turned out to be much greater than experience since World War II would have suggested.

The successive monetary easings have served to counter these contractionary forces, fending off the classic so-called bust phase that seemed invariably to follow speculative booms in pre-World War II economic history. Lower interest rates have lessened repayment burdens through the refinancing and repricing of outstanding debt, and together with higher stock prices have facilitated the restructuring of balance sheets. Indeed, considerable progress in this regard has become evident for both households and businesses. The much more subdued rate of household and business credit expansion has reduced the leverage of both sectors. Household debt service payments as a percent of disposable personal income have retraced about one-half of the runup that occurred during the previous expansion, and further progress appears in train.

Similarly, nonfinancial corporations' gross interest payments as a percent of cash-flow are estimated to have retraced much of the roughly 10 percentage point increase that occurred in the expansion. The improvements in balance sheets, together with the beneficial effects of lower interest rates, have been reflected in reduced delinquencies on consumer loans and home mortgages, increased upgradings of firms' debt ratings, and narrowed quality spreads on corporate securities.

Furthermore, lower interest rates, along with two reductions in reserve requirements, have appreciably cut the funding costs of depository lenders, materially improved interest margins, and fostered the replenishment of depository institution capital.

Although greatly moderating the potential adverse effects of the necessary adjustment process on economic activity, monetary stimulus has also stretched out the period over which adjustments will occur. A more drawnout adjustment of impaired balance sheets, as we now are experiencing, obviously is much preferable to the alternative: An adjustment through massive financial and economic contraction. Yet, the ongoing corrective process has meant that the economic expansion has been hobbled in part by the continued restraint on spending by still overleveraged and hence cautious debtors. Balance sheets ultimately will reach comfortable configurations, but even before then we should experience a quickening pace of economic activity as the grip of debt burden pressures begins to relax. Last year I characterized this process as the economy strug-

gling against a 50-mile-an-hour headwind. Today its speed is decidedly less but still appreciable.

Uncertainty about how far the process of balance sheet adjustment would have to go and for how long the spending retrenchment of overleveraged debtors would continue has been a factor in shaping Federal Reserve policy over the past few years. This uncertainty has been shared by many other observers, who, based on past experience, were somewhat skeptical about the strength and persistence of spending restraint by both the private and public sectors, and dubious about the persistence of disinflationary forces.

Against that background, more rapid or forceful easing actions more than likely would have been interpreted by market participants as risking a resurgence of inflation. That would have led to higher rather than lower long-term interest rates. As I have indicated many times before this subcommittee, Mr. Chairman, lower long-term rates are crucial in promoting progress toward more stable balance sheet structures in support of sustained economic expansion.

Bond yields have not come down more, primarily because investors have been inordinately worried about future inflation risks. While they seem to exhibit only modest concern over a reemergence of stronger inflation during the next few years, investors apparently, as you have suggested, Mr. Chairman, fear a resurgence further in the future, to a large extent as a consequence of expected outsized budget deficits exerting pressure for monetary accommodation.

Other forces have added to the restraint on the economy associated with balance sheet adjustments. The scaling back of defense spending has been retarding near-term economic growth. At the same time, budgetary problems among States and localities have forced painful cutbacks by those units and burdensome tax increases as well. In addition, the noticeable slowdown in economic growth in other major industrial countries since 1990 has further tended to depress demand for goods and services produced in the United States.

Clearly, in this environment, with conflicting forces of expansion and contraction continuing to vie for supremacy, any projection must be viewed as tenuous. In this context the central tendencies of the projections of Federal Reserve Board members and Reserve Bank presidents are given in the Board's report.

They project that the economic expansion is likely to strengthen considerably, to a range of 2¾ to 3 percent over 1993. Such a pace is expected to reduce the unemployment rate noticeably over the next 1½ years. This outlook is supported by several considerations, including the stimulation now in train from recent interest rate declines and the progress being made by borrowers and lenders in repairing strained balance sheets. Some pent-up demand for business capital goods, housing, and consumer durables should surface as the incentives for spending retrenchment abate.

In our judgment, the interest rate declines to date, working to offset spending constraints related to balance sheet strains, should not endanger the further ebbing of inflationary pressures. Even as the anticipated strengthening of economic activity occurs, monetary policy will continue to promote ongoing progress toward the

longer run objective of price stability, which should lay the foundation for sustained economic expansion.

The financial fundamentals, such as money and credit growth, point to a continuation of disinflationary trends, and the central tendency of our projections for CPI inflation next year is  $2\frac{3}{4}$  to  $3\frac{1}{4}$  percent. Were this to be realized, inflation would be about back to a pace last seen on a sustained basis around a quarter century ago.

As I have often noted to this subcommittee, the most important contribution the Federal Reserve can make to encouraging the highest sustainable growth the U.S. economy can deliver over time is to provide a backdrop of reasonably stable prices on average for business and household decisionmaking.

The relationship between money and spending also has been profoundly affected by the process of balance sheet restructuring. The broad monetary aggregates, M2 and M3, currently stand below their annual growth ranges, despite the earlier substantial declines in short-term interest rates.

My previous testimonies to the Congress noted that aberrant monetary growth emerged in 1990 and has since intensified. We at the Federal Reserve have expended a great deal of effort in studying this phenomenon, and have made some progress in understanding it.

To summarize our findings to date: The weakness of the broad monetary aggregates appears importantly to have reflected the variety of pressures that rechanneled credit flows away from depository institutions, lessening their need to issue monetary liabilities. The public, in the process of restructuring and deleveraging balance sheets, found that monetary assets had become less attractive relative to certain nonmonetary financial assets or to debt repayment.

These disintermediation and restructuring forces have tended to boost the velocity of the broader aggregates. Increased M3 velocity has been evident for some years, but the tendency for M2 velocity to rise was obscured until recent quarters by the opposing influence of declines in short-term market rates.

M2 velocity appears to have registered an appreciable increase in the first half of this year, and the Federal Reserve has had to take the emerging behavior of velocity into account in deciding how much weight to place on slow M2 growth in guiding its policy actions.

Looking ahead, Mr. Chairman, increases in M2 velocity may well continue, although the uncertainties in this regard are considerable. Predicting either the share of depository intermediation in overall credit flows or the share of money in the public's overall demand for financial assets is currently more difficult than usual.

Against this background of considerable uncertainty about evolving monetary relationships, the subcommittee retained the current ranges for money and credit growth this year. These growth ranges are  $2\frac{1}{2}$  to  $6\frac{1}{2}$  percent for M2, 1 to 5 percent for M3, and  $4\frac{1}{2}$  to  $8\frac{1}{2}$  percent for debt. This year's ranges were carried forward on a provisional basis for 1993, until such time as additional experience and analysis can be brought to bear on the issue of monetary behavior.

In any event, the FOMC will revisit the issue of its money and credit ranges for 1993 no later than its meeting next February. By

then more evidence will have accumulated about evolving monetary relationships.

In light of the difficulties in predicting velocity, signals conveyed by monetary data will have to continue to be interpreted together with other sources of information about economic developments.

I expect that the economic expansion will soon gain momentum, which lower inflation should help to maintain. Although the economy still is working its way through structural impediments to more vigorous activity, the advances that already have been made in this regard augur well for the future.

Banks and other lenders, having made considerable strides in rebuilding capital, have greater capacity to meet enlarged credit demands. The strengthening of household finances to date has established a firmer foundation for the future of consumer outlays. And the restructuring of business balance sheets so far, together with improved labor productivity and profitability, has better positioned producers to support sustainable output gains.

These gains would be even larger if the Federal Government can make significant progress toward bringing the budget into balance, releasing savings for productive private investment, and brightening further the prospects for ongoing advances in living standards for all Americans.

Thank you very much, Mr. Chairman.

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

Chairman NEAL. Thank you, sir. On page 13 of your testimony where you discuss the target ranges for money growth, you earlier pointed out in your testimony that money growth has been below target even in light of many reductions in the discount rate. You then go into some explanation for that. Wouldn't it signal even a healthy and positive increased commitment to price stability if those target ranges were reduced slightly since you are currently below the range.

I am not saying that I know that this is the proper thing to do at all; I don't. But the Fed is currently making good progress toward price stability, which is the only way we are going to get long rates down and keep them down, which will be the best thing that ever happened to this economy—every aspect of it. It just seems to me that since money growth has been so slow, that you could just capture it and march forward with these lower growth rates. What is wrong with that?

Mr. GREENSPAN. Nothing is wrong with that idea, Mr. Chairman. In fact, it is an issue which, clearly, we at the Federal Open Market Committee did discuss. We were generally in agreement that we have to bring the ranges down another notch to conform to our long-term goal of price stability. At the existing ranges, we are still a fraction higher than we should be.

The reason we forestalled moving this time was primarily because of the problems involved in relating M2 specifically to gross domestic product. That relationship has gone so far off track that until we understand the process better and understand what is going on, moving the monetary ranges would create the impression that we knew more than we know about the particular relationship.

So, before we move down to a level which we consider to be consistent with price stability, we would like to be sure that we know what that level really is, and until we have got a better sense of what is causing the aberrations that we are currently looking at, we are not quite sure where that level is.

We did not want to convey to the Congress that we have some insight about the way this process is running that we do not have. But there is no question that we are, in principle, supportive of the general view that you have just posited.

I would presume that once we have an understanding, better than we do now, about what those relationships are that the subcommittee will choose to move to a level which we consider to be consistent with price stability.

Chairman NEAL. You also indicate in your testimony that you think that you are closing in on a better understanding of these changed relationships. Would you discuss that?

Mr. GREENSPAN. We have all been extraordinarily puzzled by two facets of the relationship between money supply and the economy, and I might also add, interest rates.

One of the long-term stabilities that we have been aware of for a long period of time is that M2 in roughly its current definition has shown a remarkable stability against gross domestic product in nominal back for several decades. Indeed, one can even argue that you can carry it back into the past century.

To be sure, the relationship is not very solid on a year-by-year basis or even sometimes on a 2-year by 2-year basis, but over the long run, the general price level, if plotted against the ratio of money supply per unit of capacity, would show a remarkable parallel over a long period of time. This led us to create what we have discussed here before, our so called P-star model, which related money and prices over the long run and enabled us to get a better sense of what the relationship is between the rate of inflation over the long run and what long-term monetary policy will generate.

This, I might say, is another way of saying that over the long-run income velocity has no trend. It fluctuates up and down mainly with interest rates but it is generally flat.

That very important relationship, which essentially is the basis of a considerable amount of monetary analysis and its effect on the economy, clearly broke down, but it broke down in two ways because not only had we had this relationship between money on the one hand, M2, and the GDP on the other, but we also had a fairly predictable relationship between M2 and short-term interest rates.

A couple of years ago both of those relationships broke down. We found that despite very significant declines in short-term interest rates that money supply growth fell substantially behind what its history had indicated over the years. And that, I might add, is a reason why we continue to get money supply growth coming in under our expectations because when we postulated where we thought money supply ought to be, we, on the basis of our previous analytical insights and models, were able to set an interest rate which would create that level of money supply.

That has broken down by a substantial amount and we have now found out that the process that is going on now is really a good deal more complex and we are in the process of evaluating a much

more detailed analysis as to why individuals are not holding M2 deposits to a substantial extent as I indicated in my testimony.

It is basically the fact that the yield curve has tilted so significantly that individuals can see that they can get a significantly higher yield in holding 2-year money market instruments, mutual funds, and bond funds rather than very low-paying CDs. So a lot of money has moved out of the money supply into other instruments.

Now what is important to recognize about that is while that reduces the money supply it doesn't change people's propensity to spend and therefore, doesn't affect the GDP.

So in that process what we find is that individuals' money supplies may go down but their income levels and their spending levels will remain up so that velocity, meaning the ratio of gross domestic product divided by money supply, obviously rises under those conditions.

What we are having to do is to try to make a far better judgment, when we can fully understand this, of what type of changes in interest rates on our part, the Federal funds rate very specifically, will induce what types of changes in the money supply. We are beginning to get a better insight into why this process has turned so complex.

The reason it has turned so complex is that this is the first time really in 50 years or more where we have had this extraordinary balance sheet adjustment process which has affected, clearly, not only the economy as a whole and businesses and consumers, but it has very substantially affected financial institutions and the way people hold their own portfolios of liquid assets.

So we have that problem which we are understanding somewhat better, but we also have the more important problem, in our judgment; namely, the extraordinary divergence that has occurred between the economy as represented by nominal gross domestic product on the one hand and money supply on the other which has been going in a different direction.

Now we understand a goodly part of this. A good part of the reason is what I have just explained about the shifting away deposit of flows from depository institutions, but there are a lot of other secondary reasons. We cannot fully argue that the form of M2 no longer matters. In other words, we still believe that it has significant forecasting and analytical properties relative to the economy even though those relationships are changing.

What we are endeavoring to do is to find out what it is that has gone off and indeed, it has gone offtrack in a really dramatic way, and what we can expect, when it will inevitably come back on track, that new relationship will be.

This is not an unusual phenomenon with respect to dealing with the monetary aggregates. You may recall, Mr. Chairman, we had similar problems 7 or 8 years ago. We had difficulties with the definition of M1 which eventually led us to drop that and replace it with M2 as the crucial variable which determines monetary policy. But it is a very important issue that we at the Federal Reserve are focused on in great detail, and we are developing information in the form which we hope we may be able to present to your staff, who might be interested, at some point within the reasonably near future.

When we get it in a form which we think is usable, we will send it up here and share our results with you.

Chairman NEAL. Thank you, sir. We would love to see it. Another thing I understand you are doing along these lines is to see what it is that now is being held in something that is not called M2 that was for many years called M2. It is almost a definitional thing, isn't it?

Mr. GREENSPAN. Yes.

Chairman NEAL. If the thing is used in essentially the same way as an M2 deposit but is outside the definition that you are using, isn't that another way of going at what you are talking about?

Mr. GREENSPAN. Mr. Chairman, in the broader sense what we really want to understand is consumers' and businesses' portfolio preferences which is a very complex set of all sorts of desires to hold different types of instruments.

At the root that is ultimately what we look at, and the flow of funds accounts which we at the Federal Reserve publish are the most elaborate means that we have of getting at that very detailed set of propensities to hold different assets.

However, you cannot work at that detailed level except under very difficult circumstances and we look for proxies which capture the essence of the changes in a single statistic. That is what M2 is. It is sort of a proxy for a far more elaborate process.

Obviously, proxies change in their nature, and as a consequence of that, we have, over the years, changed the definitions to capture something which is closer to the broad propensity to move one's portfolio of assets around.

I won't say to you at the moment that we are thinking of changes because to my knowledge we are not close to recommending a change in the definition. We don't think at this point that that is what our problem is. I cannot say to you that that may not occur at some later date but we are not seeking at this point to re-define M2. We are at the moment trying to understand what the process of divergence is. In other words, to what extent is M2 either faithfully or not faithfully representing the true portfolio structure and to what extent is that portfolio structure reflecting itself in the alternatives of various different types of spending and asset choices which eventually engender the levels of gross domestic product.

Chairman NEAL. Thank you, sir. I have taken way too much time so I will now turn to my colleagues. Mr. Roth.

Mr. ROTH. Thank you, Mr. Chairman. Mr. Greenspan, you always have a very scholarly approach. I was wondering if you could help me with a little problem I have. One of my friends was asking me or wrote me a letter and said that he is buying a new house. He is getting a mortgage. He said, "What should I do? Should I get an 8½ percent fixed rate mortgage or do I go with a variable rate?" What do I tell him?

Mr. GREENSPAN. You can tell him that you spoke with the Chairman of the Federal Reserve and he didn't tell you a thing. [Laughter.]

Mr. ROTH. But if he were to tell me, what would he say? [Laughter.]

Let me ask you this. Are you buying any real estate nowadays?

Mr. GREENSPAN. No, I am not, Congressman.

Mr. ROTH. I know you don't like to comment on these things but, you know, back on the hustings now when you are out campaigning, we always talk, for example, here in Congress that we always like lower interest rates.

Quite frankly, I don't know how interest rates can go any lower than they are today because I think they are at rock bottom as I see it. Don't you think that is a good analysis?

Mr. GREENSPAN. I don't want to comment on what we might do in the future, but I will acknowledge that interest rates are, by historical standards, obviously low.

Chairman NEAL. It is short rate you are talking about, you are not talking about the long rate?

Mr. GREENSPAN. I am talking about the short rates, obviously. The long rates have a good way to go down if inflation expectations could be purged from the system.

Mr. ROTH. I have as I had mentioned before, back in the hustings at this time everybody is out running for office and I always thought that everybody wanted lower interest rates but that is not the case because we have many people that are unsophisticated investors and many times sophisticated investors who have money in CDs, especially senior citizens, so they are always coming up to me and saying, "You know, Toby, what is going to happen? Can I keep my money in CDs? I am not getting any return on them."

I always tell them that I think that interest rates will probably go up after a while. Do you think that I am telling them what I should be telling them?

Mr. GREENSPAN. Congressman, what has surprised me in the last year or so is the extent of the shift in the mail that we are getting. There were the usual long series of letters that came in with people strained with higher rates, but the most recent mail we get is very heavily weighted to concerns on the part of mainly retired people who have banked upon a level of interest rates and a level of interest income which they are not able to get.

It is important when one looks at the flows of interest income in evaluating where the economy is going and all economists and financial analysts will agree that net, on balance, the lower the real rate of interest in an economy, the more productive that economy is going to be. And we seek to achieve that.

It doesn't necessarily follow that it is a uniformly positive event for everybody because it is not. It obviously depends on whether you are a borrower or a lender. It clearly has a very material effect especially when interest rates change as much as they have in the short end of the market in the last several years.

Mr. ROTH. You had mentioned before in your discussion with the chairman here and I see on your page 8 and I underlined it, this aberrant monetary behavior. As I see it, the element is one of confidence and no matter how low you have the interest rates, the confidence is going to be a factor.

Again, maybe I am zeroing in too much what I hear on the street but I know when I am talking with people back home like people will say to me that I don't care how low interest rates are, I am not going to borrow any more money. So I have come to the conclusion that no matter what you do with the interest rates, you have to do

something with this confidence level of the general public. Am I misreading that?

Mr. GREENSPAN. No. On the contrary, you are focusing on what is the most crucial issue in the consumer sector. One of the things, however, that we think will be a key factor in that is the eventual elimination of the excess debt burden which households are currently working very hard to remove.

I would suspect that when debt service burdens get back to whatever constitutes normal, a goodly part of the fear and concern that a lot of people have with the excess debts they are carrying will disappear and confidence in their own financial state will reemerge.

Confidence is not something which just happens by chance. It happens for reasons. When we see a much better balance sheet structure, I would say any of us would feel far more comfortable about spending if we knew that our debt service burdens were controllable but if they were high, it undoubtedly would tend to restrain our propensity to spend.

Mr. ROTH. This is one of the questions that I have rolled around in my head for a long time, this question of what happens to mass psychology. In politics, you can feel it because when you go back home, you can feel these mood swings and I have never seen a mood swing in my lifetime as negative as it is today. I am asking myself, what causes these mood swings?

Mr. GREENSPAN. As I have mentioned to this subcommittee on occasion, that it is not the short term. I don't think that one can look at the state of the economy at the moment even with the strained balance sheets and the difficulties that go on and understand the low levels of consumer confidence, that we reached say, 6 months ago.

It had to be a concern about what is going to happen some time out in the future. I characterized it as being to a large extent the concern about whether or not our children and grandchildren would live at standards of living comparable to our own.

It is an extremely deep-seated type of concern because as bad as things are—and they certainly are not good—in comparison to other periods in fairly recent American economic history conditions are not as bad. So why we feel that sense of concern has got to reflect not the immediate period but a sense that there is something foreboding out in the longer term and that is what I find most disturbing about the nature of confidence in this country at this stage.

Mr. ROTH. I really appreciate that explanation. I think that is about the best answer I have ever gotten from anybody really and aside from that I think the foreboding is that people fear, well, I am going to do everything I can to get the President reelected.

Chairman NEAL. Mr. Neal.

Mr. NEAL OF MASSACHUSETTS. Thank you, Mr. Chairman. I think that is the foreboding factor. [Laughter.]

Mr. ROTH. Yes, that he is not going to be reelected, right?

Mr. NEAL OF MASSACHUSETTS. Not exactly. Thank you very much, Mr. Chairman. I think it is interesting that when we have an opportunity, Mr. Chairman, to sit here and to speak of M1 policy and M2 policy, but the simple truth is that those of us in elective office, we rely on anecdotal evidence and as I have suggested before,

short-term interest rates might be down but the unemployment lines in New England aren't down.

When we sit here and say that we don't understand why the consumer doesn't have any confidence, all one has to do is drive past the unemployment office on a Monday morning and you can understand quickly why they don't have any confidence.

Mr. GREENSPAN. All that does is to bring the question back to what is creating the unemployment which I certainly agree is crucial to the question. I am not arguing that consumer confidence is not caused by or unrelated to what is going on in the world-at-large, and there is no question that that element, I would say not so much the level of unemployment as the rate of layoffs, has been clearly related to the degree of consumer confidence because that people's basic view as to whether their jobs are in jeopardy is the most important element which affects them.

So if you have a level of unemployment, for example, which may be moderate or even low but it is rising, meaning that the layoff rate is high, I would suspect that you will find that consumer confidence is deteriorating fast even though the level of unemployment may not be all that high but it is rising. It is the change in unemployment that most clearly relates to this phenomenon.

Mr. NEAL OF MASSACHUSETTS. I think that is an accurate observation. In addition to which, when we talk about layoffs, at one time that there might have been layoffs, today the factory down the street closes.

Mr. GREENSPAN. It is not a layoff, that is a job lost.

Mr. NEAL OF MASSACHUSETTS. That's right, and then we talk about the foreboding factor. The individual reacts just as they should be reacting in this atmosphere, right?

Mr. GREENSPAN. Yes.

Mr. NEAL OF MASSACHUSETTS. Let me follow up with another question because I have talked to you a number of times in the past about bank lending policies in New England. Do you see any evidence that that has gotten better?

Mr. GREENSPAN. Only marginally, Congressman. It is still unacceptable in my view.

Mr. NEAL OF MASSACHUSETTS. Are you willing to say that I was right a year ago?

Mr. GREENSPAN. About your concern?

Mr. NEAL OF MASSACHUSETTS. Yes.

Mr. GREENSPAN. I don't think I said that you were wrong a year ago as I recall.

Mr. NEAL OF MASSACHUSETTS. You kind of tiptoed around it though.

Mr. GREENSPAN. Well, I usually tiptoe around most things.

Mr. NEAL OF MASSACHUSETTS. I have noticed. [Laughter.]

Mr. GREENSPAN. All I can say to you, Congressman, is when the issue comes up either I or my colleagues invariably quote you. So we have been inculcated with your point of view at considerable length. Dick Syron whom you know, the President of the Federal Reserve Bank of Boston, and I talk about it quite a lot, and the problems in New England in the financial area clearly have been extraordinary.

Fortunately, banking is getting better but the issue of loans to medium-sized and small business are only marginally better as best as I can see, and as I have indicated elsewhere, one of the problems that we are endeavoring to which we think might have some effect, is to try to eliminate the so-called leverage ratio in bank supervision by essentially getting the detailed means of evaluation of interest rate risk—which is what the leverage ratio is supposed to measure—embodied in another way in our risk-based capital system and eliminate what, in my judgment at least, is a much too draconian tool to achieve what it is endeavoring to do.

However, I am not altogether certain that that solves all of the problems that we see on the lending front. As I mentioned to your colleagues on the other side of the Hill yesterday, there is very clear evidence that the extraordinarily stagnant loan growth is a function basically of just weak loan demand on the one hand and, to an extent which I still find unacceptable, restrictive lending policies on the other.

While we can work on both sides, we do have more effective capabilities for trying to find ways in which we can improve the willingness on the part of banks to lend to creditworthy customers.

Mr. NEAL OF MASSACHUSETTS. That kind of leads to the next question. The banks back in New England are reporting pretty substantial profits. Now it is difficult for the layman to gauge what that really means. But certainly, when you look at the stock, when you look at the layoffs, you have to assume that the banks are in much better position than they were just a few months ago. Why the reticence on their part about lending?

Mr. GREENSPAN. They were so traumatized by the lending periods which created huge threats to the capital position and the viability of the franchise of the banks that it has not worn off yet.

In other words, we are clearly far from where we were say a year ago; that is, the balance sheet positions of the banks, the capital positions, and the liquidity positions are all very materially improved.

But they are still extraordinarily sensitive to such things, for example, as making a commercial mortgage. You can get the anecdotal, apocryphal, or, however you want to describe it, stories of individuals who are willing to put up collateral, 50 percent down, and have signed lease contracts with the U.S. Government for 20 years or the life of the building, and they are still not able to get a loan largely because the title, "commercial real estate loan" sitting on the balance sheet is something which either frightens the loan officer or is something which he perceives the shareholder, the SEC, and the bank regulatory agencies will all look askance at.

Mr. NEAL OF MASSACHUSETTS. Mr. Chairman, could I ask one additional question?

Chairman NEAL. Certainly.

Mr. NEAL OF MASSACHUSETTS. Isn't it, in a sense, intellectually dishonest to be reporting these near record profits and then not performing the obligation that you are publicly chartered to perform?

Mr. GREENSPAN. No. I wouldn't agree with that, Congressman. The issue of whether one is profitable as a depository institution is a very tricky accounting process and to give you an extreme case,

take a savings and loan which has nothing but 30-year mortgages and short-term deposits. It really doesn't know in any particular quarter whether it made money or not because it won't know until way after the fact when all of those 30-year mortgages are paid off because you never know whether what you are getting is either interest income and therefore, profits, or a payment of principal in part because a mortgage which ultimately defaults in retrospect should be perceived of as having paid no interest at all and only represented a repayment of principal.

In other words, you would be in a position where you cannot assume that what the borrower is paying you is interest on the mortgage itself. To a lesser extent, that same problem exists with commercial banking, only the assets are much shorter term. But accounting for bank profits or any financial intermediaries' profits is not a simple sort of thing.

With their outside auditors and with the accounting practices required by the SEC and the FASB, there is very little leverage in what an individual bank can report with respect to its earnings because there are certain standards we have all set up because it is so difficult to get an evaluation of earnings.

So I wouldn't necessarily argue that if they have earnings that, therefore, in their judgment their lending inclinations should increase.

Mr. NEAL OF MASSACHUSETTS. Let me rephrase that then. Do you think that banks have been slow to pass on the discount rate to the customer?

Mr. GREENSPAN. Yes, I do.

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

Mr. GREENSPAN. You should have asked me that first. [Laughter.]

Chairman NEAL. This discussion of confidence and the public's view of the future and themselves doesn't seem to me is very irrational at all. No one said it was. I am not trying to put words in anyone's mouth but it also doesn't seem to me that it is very hard to understand why many people feel somewhat uncertain about the future, because we are undergoing a period of change in the world, and the world is now a changed place. In some ways, there is very positive change. I mean the unwinding of the Soviet Empire is a wonderful change for the world. On the other hand, we haven't fully adjusted fiscal policy to recognize some of these new realities. We have had a fiscal policy for the last 12 years that has quadrupled the national debt. It did a lot of good things. It gave people a nice ride during this period of time, and a lot of good feeling, and we were able, with a lot of that deficit, to continue a bipartisan commitment to a defense that would, in fact, contain the Soviet Union, contain communism.

It was a bipartisan effort that began after the Second World War and it cost money. Certainly, a lot of the money that was spent over the last several years was for that purpose and it worked. That is the reason for great optimism, it seems to me.

On the other hand, during the period we built up a defense and we lowered taxes, but we built up our military on debt and now the debts are coming due. I didn't support the policy at the time because it seemed to me to be unbalanced. It didn't make sense. It didn't add up. However, it was a popular policy that President

Reagan sold to the public and he got enough people in Congress to support it that he got what he wanted. President Bush has gotten what he wanted. He has succeeded with every detail.

You know, there is not one penny of Federal spending on the books that President Bush doesn't approve of. If he had wanted to cancel any Federal spending, all he would have to do is veto a bill and we couldn't override the veto. I am not trying to get too partisan here but we do need to understand what happened and how to correct things for the future. Now we have a big debt. We need to get rid of it and we can. I think this is something that hasn't quite sunk in yet. I am certainly not going to ask you to get into any partisan debate. Let me back up a minute and say that we are off the track a little bit because this hearing has to do with monetary policy. It seems to me that the conclusion of this hearing and the others we have had is that there is only so much you can do with monetary policy. If you go too far in bringing down short rates, you are going to raise long rates and that is going to bring the economy crashing down, evidently. It is an inevitable tradeoff. There is no way of getting around it, and it seems to me that there is some concern already out there that the Fed may have gone a little too far and that long rates may creep up. But any way, we will see. I hope that is not the case and it is something that could be corrected.

There is only so much the Fed can do. It is a huge element in the economy. It can keep us from inflating the economy, that is the best way to keep employment up and keep savings up, keep growth up and it is the best way to get interest rates down. The question is, is the Fed doing all it can in that area and I don't know how you could do any better. I thank you. If I could find things to fault, I would be happy because that gets press. That would be good for me. But I don't know how you could have done much more. You are moving toward zero inflation. I always hope that you get there a little quicker but anyway, you have to be careful about the rest of the economy. You can't go too fast. You have done that. You brought short rates down a lot.

On the other half of the economy is the fiscal side. I would be pretty optimistic about that. I wonder if you would comment on this. We have a \$360 to \$400 billion deficit, and an estimated \$100 billion of that is the result of the recession, they tell us. I wonder if you agree with that? Another \$80 billion or so is the savings and loan problem, which ought to be a one-time thing. We have most of that behind us, so that leaves a core deficit of about \$200 billion. \$200 billion is manageable if we would get serious about it. I don't frankly think anyone has gotten terribly serious but if we would freeze spending or do something close to that and maybe cut a little bit more out of defense and maybe go up a little bit on taxes, we could lower the deficit by \$40 billion to \$50 billion a year. If we had the political will to just do those things, we could get rid of that deficit in 4 or 5 years. Is that right? Do you think in the first place that the deficit is about the size I suggested and couldn't we deal with it in roughly the way I suggest?

Mr. GREENSPAN. Well, I think you are quite right, Mr. Chairman. If you want to put it in the sense of what is the level of the deficit which has to be cut to get to balance and will not be implemented by the eventual elimination of the costs of deposit insurance or af-

fectured by the business cycle—the core deficit is at about a \$200 billion level which we do not seem able to get beneath.

Indeed, the very detailed simulations of the budget deficit show that if you get out to the years 1995 and 1996 that with the eventual elimination of the deposit insurance costs and, say, a restoration of reasonably full employment, you get down to about \$200 billion and that is as low as it goes.

Chairman NEAL. Without us doing something.

Mr. GREENSPAN. Yes. Then what starts to happen is that it starts to edge back up again.

Chairman NEAL. Right.

Mr. GREENSPAN. It is that \$200 billion that requires actual actions to eliminate. In other words, the current services budget has got to be cut by that much for fiscal 1995-1996.

Chairman NEAL. Now I suggested a way of doing it, does that sound realistic to you? Would that get there?

Mr. GREENSPAN. You mean \$50 billion a year or something of that sort?

Chairman NEAL. Yes, something like that.

Mr. GREENSPAN. Sure. If you could find the means to do it, that would get us there.

Chairman NEAL. That just seems to me to be doable. Mr. Roth wants to say something. I will yield and then I will come back.

Mr. ROTH. I just have one short question. I was going to ask you about the dollar dropping and if you were concerned about that but before I ask you that question, I want to just make a short statement. After the Senate yesterday and our chairman today when George Bush looks at his shins, they are going to be mighty black and blue.

My good friend, the chairman, said that the President got all he wanted. Did he get the line-item veto, did he get the balanced budget amendment, did he get his economic growth package? Why, God, we could go on ad infinitum but it shows that divided government does not work. But I can say categorically that if President Bush wins on November 3 and for the first time in 38 years we get a Republican House, we will have a balanced budget and we will have lower taxes and we will have a stronger economy.

With that aside, I was just going to ask you the question about the dollar.

Mr. NEAL OF MASSACHUSETTS. Mr. Chairman, can it safely be said that that has been put aside? [Laughter.]

Mr. ROTH. I was going to ask the question about the dollar, if you were concerned about that because there is so much speculation about that today.

Mr. GREENSPAN. I just merely will repeat what I said to the Senate yesterday. I see no net benefit to the American economy from further depreciation of the dollar. It doesn't strike me that we can somehow stimulate exports at the expense of others and engender increasing internal inflation and end up significantly better off over the long run. It is not a policy which I would subscribe to.

Mr. ROTH. Thank you.

Chairman NEAL. But you didn't cause that either. The market is causing the value of the dollar to change, isn't it?

Mr. GREENSPAN. A substantial part of the decline of the dollar reflects the differential interest rates between dollar-denominated instruments on the one hand and mark- and yen-denominated and other currency-denominated instruments on the other. But that doesn't explain all of the decline that we have experienced in the recent weeks.

Mr. ROTH. Thank you very much.

Chairman NEAL. I have a quick question and there is one thing I don't understand from your testimony. You suggest in your testimony that debt restructuring is a prime cause of economic sluggishness and I agree with you by the way. It makes sense to me on an empirical level but what I don't quite understand is the whole process because if a household or a business reduces its spending to repay debt then some other household or business receives the payment and that happens on down the line and someone ends up with some money. Now what happens to that money?

Mr. GREENSPAN. It doesn't quite work that way. The best way of looking at it is to think in terms of whether the cash-flow one gets is spent or saved. If you say you are getting \$100 a week and you spend say \$70 of that, the other \$30 either has to be reflective of an increase in your assets or a decrease in your liabilities.

The point that I am trying to make is that the phenomenon that we are seeing at this particular stage is that because of the balance sheet problems, because of the fact that a lot of money was borrowed against an expectation of rising asset values, and when those asset values fell instead, one is still burdened with the debt and the costs of the debt.

What has occurred is an increased proportion of the cash-flow say in a household, the wage and salary income, is being used to pay off the debt and in a sense, the inclination on the part of the household in that particular case obviously is to save more.

Now the dilemma in the statistics is why then don't we see a significant rise in the overall saving rate, and although we see some, the answer to that is that the levels of income have not increased. They have, in fact, been suppressed by this process.

So it doesn't show up after the fact, ex post, as economists like to say, in a higher measured saving rate. But what is occurring is that people are basically paying off debt and what that does is instead of moving the funds from one place to the other it cancels them. In other words, the money, if you want to think of it in a circulating sense, comes in the front door and instead of going out the back door, it disappears.

Chairman NEAL. Thank you. I think you set off a little storm here somehow in response to the question on the value of the dollar. You may want to say something to make your position clear. You don't set the value of the dollar though you have some indirect influence on it. Is there anything you want to say to be clear on our policy?

Mr. GREENSPAN. No, I said what I believe.

Chairman NEAL. You are not going to maintain the value of the dollar at some level?

Mr. GREENSPAN. No. That is not obviously what our basic policy is. As I have indicated to you previously, the value of the dollar is a key element in our economic outlook. It affects it. To the extent

that we envisage that changes in dollar values have impact on economic events within the United States, clearly that is something which we focus on.

Chairman NEAL. Thank you very much. We have a vote on and I just want to thank you again for your testimony this morning. We appreciate your being here. Thank you.

Mr. GREENSPAN. Thank you very much.

Chairman NEAL. The subcommittee stands adjourned.

[Whereupon at 11:22 a.m., the hearing was adjourned.]

APPENDIX

July 23, 1992

## OPENING STATEMENT

**The Honorable Stephen L. Neal, Chairman****Subcommittee on Domestic Monetary Policy***July 22, 1992*

The Subcommittee meets this morning to welcome Chairman Greenspan for the presentation of the Federal Reserve's semi-annual monetary policy report to Congress. I would like to begin by congratulating the Chairman for the moderate and cautious approach the Fed seems to have taken on monetary policy so far this year. It has faced, and continues to face, sharply conflicting pressures. On one side it confronts a growing chorus of demands for ever greater monetary stimulus and ever sharper decreases in the Fed Funds Rate. On the other it finds a persistent skepticism in the financial markets on the long-term outlook for inflation, and an unwillingness to bid down long rates in line with the Fed-induced fall in short rates.

Though the Fed's cautious easing so far this year seems appropriate, the Chairman's testimony this morning offers two convincing reasons to believe the Fed has reached the limit of acceptable monetary stimulus. He states, in effect, that the current weakness in the broad monetary aggregates does **not** signal similar weakness in future economic growth. In other words, monetary policy does not need to boost M2 growth significantly in order to promote healthy economic recovery. Robust economic growth is not being hampered by a shortage of money, or, more broadly stated, by insufficient financial liquidity.

Robust growth is, however, being hampered by "balance sheet restructuring" throughout the economy. Spending units of all kinds — households and businesses — are attempting to reduce outstanding debt. In the process they spend and invest less, out of a given income or cash flow, than they normally would. That inhibits economic growth.

If, as the Chairman also indicates, the financial markets are not yet prepared to reduce long rates very much in response to monetary ease, it should be evident that aggressive easing beyond this point can contribute little or nothing to the necessary rebuilding of healthier balance sheets. We must simply let that process run its course, and take care not to endanger, in the interim, the progress the Fed is making toward zero inflation, or price stability. Nothing would be more useful for the economy than for the financial markets to become convinced that inflation will decline, not just over the next two years, but over the next two decades, to virtually nil. Then long rates would fall sharply, economic growth would surge, debt could be more easily retired or refinanced at better terms.

The Fed cannot bring this about by aggressive easing. In fact, it can do nothing to bring it about by itself, other than continue doggedly on a course that will eventually wring inflation out of the economy despite what the markets expect. It needs help from the political system, in the form of serious support for a long-term commitment to price stability instead of constant and misguided carping for aggressive monetary ease.

This incessant pressure for ease is often justified by the argument that inflation is no longer a problem, that it is somehow "under control." That is, alas, far from true. Measured inflation has fallen a little, and may fall a little more in the near future. The problem, however, is that inflationary expectations over time horizons that really count for investment and savings decisions — 10 to 20 years, for example — remain excessively high. We will not have inflation under control, we will not enjoy lower long-term interest rates, we will not begin to reap the benefits of price stability — until the Fed breaks the back of inflationary expectations. It has not yet done that, so inflation is not yet "under control." Getting it under control — breaking the grip of high inflationary expectations on long-term interest rates — must remain the foremost priority of monetary policy.

Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

July 22, 1992

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to present the Board's semiannual report on monetary policy to the Congress. Earlier this month, when the Federal Open Market Committee formulated its plans and objectives for the next year and a half, it did so against the backdrop of an economy still working its way through serious structural imbalances that have inhibited the pace of economic expansion. In light of the resulting sluggishness in the economy and of persistent weakness in credit and money, the System on July 2 cut the discount rate by 1/2 percentage point, and eased reserve market conditions commensurately. These actions followed a reduction in the federal funds rate in early April. The recent easings of reserve conditions should help to shore up the economy, and coming in the context of a solid trend toward lower inflation, have contributed to laying a foundation for a sustained expansion of the U.S. economy.

The U.S. economy and monetary policy

Our recent policy moves were just the latest in a series of twenty-three separate easing steps, beginning more than three years ago. In total, short-term market interest rates have been reduced by two-thirds. The federal funds rate, for example, has declined from almost 10 percent in mid-1989 to 3-1/4 percent currently. The discount rate has been cut to 3 percent--a twenty-nine year low. Despite the cumulative size of these steps, the economic recovery to date nonetheless has been very hesitant. Based on experience over the past three or four decades, most forecasters would have predicted that a reduction of the magnitude seen in short-term interest rates,

nominal and real, during the past three years would by now have been associated with a far more robust economic expansion.

Clearly the structural imbalances in the economy have proven more severe and more enduring than many had previously thought. The economy still is recuperating from past excesses involving a generalized overreliance on debt to finance asset accumulation. Many of these activities were based largely on inflated expectations of future asset prices and income growth. In short, an overbuilding and overbuying of certain capital and consumer goods was made possible by overleverage. And, when realities inevitably fell short of expectations, businesses and individuals left with debt-burdened balance sheets diverted cash flows to debt repayment at the expense of spending, while lenders turned considerably more cautious.

This phenomenon is not unique to the United States. To a greater or lesser extent, similar adjustments have gripped Japan, Canada, Australia, the United Kingdom, and a number of northern European countries. For the first time in a half century or more, several industrial countries have been confronted at roughly the same time with asset-price deflation and the inevitable consequences. Despite widespread problems, we seem to have at least avoided the crises that historically have been associated with such periods in the past.

In the United States especially, important economic dynamics ensued as the speculative acquisition of physical assets financed by debt outpaced fundamental demands. In some markets for physical assets, such as office buildings, a severe oversupply emerged, and prices plummeted. In others, such as residential housing, average price appreciation unexpectedly came to a virtual standstill, and

prices fell substantially in some regions. Firms that had been subject to leveraged buyouts based on overly optimistic assumptions about the future values at which assets could be sold began to encounter debt servicing problems.

More generally, disappointing earnings and downward adjustment in the values of assets brought about reduced net worth positions and worsened debt-repayment burdens. Creditors naturally pulled back from making risky loans and investments, and as pressures mounted on lenders' earnings and capital, some features of a "credit crunch" appeared. With borrowers themselves becoming more cautious about taking on more debt, as well as about spending, credit flows to nonfederal sectors diminished appreciably.

It is not that this process was unforeseeable in the latter years of the 1980s. The sharp increase in debt and the unprecedented liquidation of corporate equity clearly were unsustainable and would eventually require a period of adjustment. What was unclear was the point at which financial problems would begin to constrain spending and how strong those constraints would be. Forecasts of difficulties with debt and strained balance sheets had surfaced from time to time over the past decade. But only in recent years did it become apparent that debt leverage had reached its limits, inducing consumers and businesses to retrench. Moreover, the degree of retrenchment has turned out to be much greater than experience since World War II would have suggested.

The successive monetary easings have served to counter these contractionary forces, fending off the classic "bust" phase that seemed invariably to follow speculative booms in pre-World War II economic history. During those severe episodes, sharp declines in

output and income were associated with a freezing up of credit availability, widespread bankruptcies by borrowers, and closings of newly insolvent financial institutions. Thus, balance sheets were cleansed only through the massive writing off of loans, involving a widespread destruction of creditor capital.

To be sure, elements of this historical process have been at work in recent years, but the monetary policy stimulus since mid-1989 has forestalled such a severe breakdown. Lower interest rates have lessened repayment burdens through the refinancing and repricing of outstanding debt, and together with higher stock prices have facilitated the restructuring of balance sheets. Indeed, considerable progress in this regard has become evident for both households and businesses. The much more subdued rate of household and business credit expansion has reduced the leverage of both sectors. Household debt service payments as a percent of disposable personal income have retraced around one-half of the runup that occurred during the previous expansion, and further progress appears in train. Similarly, nonfinancial corporations' gross interest payments as a percent of cash flow are estimated to have retraced much of the roughly 10 percentage point increase that occurred in the expansion. The improvements in balance sheets, together with the beneficial effects of lower interest rates, have been reflected in reduced delinquencies on consumer loans and home mortgages, increased upgradings of firms' debt ratings, and narrowed quality spreads on corporate securities. Furthermore, lower interest rates, along with two reductions in reserve requirements, have appreciably cut the funding costs of depository lenders, materially improved interest margins, and fostered the replenishment of depository institution capital.

Although greatly moderating the potential adverse effects of the necessary adjustment process on economic activity, monetary stimulus also has stretched out the period over which adjustments will occur. A more drawn out adjustment of impaired balance sheets, as we now are experiencing, obviously is much preferable to the alternative: an adjustment through massive financial and economic contraction. Yet the ongoing corrective process has meant that the economic expansion has been hobbled in part by the continued restraint on spending by still overleveraged and hence cautious debtors. Balance sheets ultimately will reach comfortable configurations, but even before then we should experience a quickening pace of economic activity as the grip of debt burden pressures begins to relax. Last year I characterized this process as the economy struggling against a 50-mile-an-hour headwind. Today its speed is decidedly less, but still appreciable.

Uncertainty about how far the process of balance-sheet adjustment would have to go and for how long the spending retrenchment of overleveraged debtors would continue has been a factor in shaping Federal Reserve policy over the past few years. This uncertainty has been shared by many other observers, who, based on past experience, were somewhat skeptical about the strength and persistence of spending restraint by both the private and public sectors, and dubious about the persistence of disinflationary forces. Against that background, more rapid or forceful easing actions more than likely would have been interpreted by market participants as risking a resurgence of inflation. That would have led to higher rather than lower long-term interest rates. As I have indicated many times before this Committee, lower long-term rates are crucial in promoting progress toward more

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stable balance sheet structures in support of sustained economic expansion.

In fact, long-term interest rates have stayed disturbingly high in the face of sharply lower short-term rates. A greater decline in long rates would have encouraged additional restructuring of business and household balance sheets and fostered stronger spending on business fixed investment goods, housing, and consumer durables. Bond yields have not come down more primarily because investors have been inordinately worried about future inflation risks. While they seem to exhibit only modest concern over a reemergence of stronger inflation during the next few years, investors apparently fear a resurgence further in the future, to a large extent as a consequence of expected outsized budget deficits exerting pressure for monetary accommodation.

Other forces have added to the restraint on the economy associated with balance sheet adjustments. The scaling back of defense spending has been retarding near-term economic growth. A significant reallocation of resources is an inevitable consequence of the phase-down of defense spending, involving the redeployment of military personnel as well as industrial and technological capacity into civilian activities. Such shifting of resources away from military production promises a welcome boost to long-run prospects for the nation's productivity and growth. Nonetheless, the process of transition involves significant frictions and lags, and in the meantime the falloff of the military budget has represented a drag on aggregate demand. At the same time, budgetary problems among states and localities have forced painful cutbacks by those units and burdensome tax increases as well.

In addition, the noticeable slowdown in economic growth in other major industrial countries since mid-1990 has further tended to depress demand for goods and services produced in the United States. Fortunately, continued rapid economic growth on the part of developing countries, whose imports from the United States have grown in relative importance, has prevented a greater weakening in the expansion of our exports.

The U.S. economic outlook

Clearly in this environment, with conflicting forces of expansion and contraction continuing to vie for supremacy, any projection must be viewed as tenuous. In this context, the central tendencies of the projections of Federal Reserve Board members and Reserve Bank presidents are given in the Board's report. They project that the economic expansion is likely to strengthen moderately, to a range of 2-3/4 to 3 percent over 1993. Such a pace is expected to reduce the unemployment rate noticeably over the next year and a half. This outlook is supported by several considerations, including the stimulus now in train from recent interest rate declines and the progress being made by borrowers and lenders in repairing strained balance sheets. Some pent-up demand for business capital goods, housing, and consumer durables should surface as the incentives for spending retrenchment abate.

In our judgment, the interest rate declines to date, working to offset spending constraints related to balance-sheet strains, should not endanger the further ebbing of inflationary pressures. Even as the anticipated strengthening of economic activity occurs, monetary policy will continue to promote ongoing progress toward the longer-run objective of price stability, which should lay the

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foundation for sustained economic expansion. The financial fundamentals, such as money and credit growth, point to a continuation of disinflationary trends, and the central tendency of our projections for CPI inflation next year is 2-3/4 to 3-1/4 percent. Were this to be realized, inflation would be about back to a pace last seen on a sustained basis around a quarter century ago. As I often have noted to this Committee, the most important contribution the Federal Reserve can make to encouraging the highest sustainable growth the U.S. economy can deliver over time is to provide a backdrop of reasonably stable prices on average for business and household decision-making.

Recent behavior of the monetary aggregates

The relationship between money and spending also has been profoundly affected by the process of balance sheet restructuring. The broad monetary aggregates, M2 and M3, currently stand below their annual growth ranges, despite the earlier substantial declines in short-term interest rates. My previous testimonies to the Congress noted that aberrant monetary behavior emerged in 1990 and has since intensified. We at the Federal Reserve have expended a great deal of effort in studying this phenomenon, and have made some progress in understanding it. To summarize our findings to date: The weakness of the broad monetary aggregates appears importantly to have reflected the variety of pressures that rechannelled credit flows away from depository institutions, lessening their need to issue monetary liabilities. The public, in the process of restructuring and deleveraging balance sheets, found that monetary assets had become less attractive relative to certain nonmonetary financial assets or to debt repayment.

The reduced depository intermediation stemmed from emerging problems of asset quality, which in turn prompted both the pulling back of depositories from lending and responses by regulators that reinforced those tendencies. One such response was the shutting down or sale of insolvent thrift institutions. In the process, some \$90 billion of thrift assets have been taken onto the books of the Resolution Trust Corporation, where they are funded by government securities instead of depository liabilities. The managed liabilities of depositories have been most affected by this shift. However, retail depositors also have been induced to shift into other instruments by the abrogation of their original contracts by acquiring institutions and the consequent disruption of their banking relationships.

At banks and solvent thrifts as well, problems of asset quality, especially for commercial real estate, were mounting as the 1980s came to a close. Banks reacted by tightening their nonprice lending terms and credit standards appreciably and widening the spread of lending rates relative to costs of funds. Upward pressure on bank loan rates was augmented as investors, concerned about adequate bank capitalization, raised risk premiums on bank debt and short-term managed liabilities. In addition, regulatory initiatives, such as stricter capital standards, higher insurance premiums, and more intense supervisory scrutiny, raised the cost of depository intermediation. Reserve requirement cuts have represented only a partial offset. As intermediation costs rose, banks further increased loan spreads and redoubled efforts to securitize loans and otherwise constrain expansion in their balance sheets.

More recently, the decline in short-term market rates, combined with the improvement in asset quality that was partly associated with the modest economic expansion, has considerably boosted bank earnings. Banks also have strengthened their financial condition by improving their liquidity position and by taking steps that should reduce noninterest expenses over the long run through restructuring and, in some cases, consolidation. A number of banks--especially large banks--have conserved capital by reducing dividends. Banks have regained access to capital markets and have significantly rebuilt their capital positions. Intermediation costs and pressures to bolster capital, however, have been further elevated by the added restrictions contained in the FDIC Improvement Act. Partly as a consequence, lending spreads have stayed relatively high, as suggested by a prime rate that is a substantial 2-3/4 percentage points above the federal funds rate. Recent survey responses suggest that nonprice terms and lending standards, though not tightening further, also have remained stringent.

Bank lending has shown few signs of strengthening, as demands for bank loans have stayed dormant. The internal cash flows of nonfinancial businesses have strengthened, and many firms have raised substantial funds in equity markets, so overall credit demands have been light. Large firms, especially those with good credit ratings, have preferred bond markets over banks as a place to borrow. Meanwhile, households, feeling the strain of debt service burdens, have rechannelled cash flows away from retail deposits to the repayment of consumer debt at banks and other lenders. They were also encouraged to deleverage their balance sheets by the wider spread between consumer loan rates and retail deposit rates, which was

accentuated on an after-tax basis by the phase-out of the tax-deductibility of interest payments on consumer loans.

With little need for new funding, banks and thrifts have lowered rates on retail time deposits, especially on intermediate- and long-term accounts, by more than market rates have declined. Under regulatory pressure, banks also have cut back reliance on, and returns to, brokered deposits. Even on NOW accounts, savings deposits, and money market deposit accounts, where inflows have strengthened, returns on the larger accounts--likely involving the most interest-sensitive depositors--have dropped much faster than have the most common rates paid. The comparatively high returns on longer-term debt and equity instruments also have drawn household assets out of retail deposits. Bond and stock mutual funds in particular have recorded substantial inflows.

Thus, the weakness in the broader monetary aggregates, which has been even more pronounced this year, can be seen as an aspect of the entire process of rechanneling credit flows away from depositories and of restructuring the public's balance sheets. However, the disintermediation and restructuring forces, which have acted powerfully to depress the growth of money, have exerted a less powerful constraint on spending; that is, slower money growth has not tended to show through percentage point for percentage point to reduced nominal GDP expansion. Accordingly, these disintermediation and restructuring forces have tended to boost the velocity of the broader aggregates. Increasing M3 velocity has been evident for some years, but the tendency for M2 velocity to rise was obscured until recent quarters by the opposing influence of declines in short-term market rates. Lower short rates reduced the potential returns given

up by holding liquid M2 balances, thereby providing support to demands for M2 and countering the emerging tendency for its velocity to increase. But M2 velocity appears to have registered an appreciable increase in the first half of this year, and the Federal Reserve has had to take the emerging behavior of velocity into account in deciding how much weight to place on slow M2 growth in guiding its policy actions.

Prospective behavior of the monetary aggregates

Looking ahead, the recent increases in M2 velocity may well continue, although the uncertainties in this regard are considerable. Returns on short-term market instruments relative to rates on M2 balances have dropped to unprecedented lows. Depositories may well reduce liquid deposit rates further to restore longer-run relationships with money-market rates. Should this occur, the resulting shifts in assets would reduce M2 demand without much influencing spending, further boosting the velocity of this aggregate. The velocity of M2 also would tend to increase if any pickup in credit availability at banks associated with stronger economic expansion were funded out of their sizable holdings of liquid securities and newly issued managed liabilities rather than through recourse to retail deposits.

Another significant imponderable involves the public's demand for M2 balances. The extent to which households will continue to repay or avoid debt by drawing down M2 balances is difficult to foresee with any precision, as one cannot accurately gauge households' desired leverage positions. An early completion of household balance-sheet adjustments would help to restore incentives to build liquid money balances, cutting into increases in M2 velocity. Any decline in

long-term market rates could dissuade households from reaching for better returns out the yield curve beyond M2 maturities, and thereby bolster M2 demands even more than it would spending. This would further offset the tendency for disintermediation and deleveraging to raise M2 velocity. All told, predicting either the share of depository intermediation in overall credit flows or the share of money in the public's overall demand for financial assets is currently more difficult than usual.

Against this background of considerable uncertainty about evolving monetary relationships, the Committee retained the current ranges for money and credit growth this year. These growth ranges are 2-1/2 to 6-1/2 percent for M2, 1 to 5 percent for M3, and 4-1/2 to 8-1/2 percent for debt. On a provisional basis, the same ranges also were carried over to next year.

If velocities were to show little further increase, then growth of the monetary aggregates within these specified ranges for both years would be consistent with the achievement of noninflationary economic expansion. The reduction in short-term interest rates resulting from our recent policy action enhances the odds on money growing within these ranges. On the other hand, if the unusual velocity increases seen so far this year were to persist over the next six quarters, then growth of M2 and M3 around or even below the lower bounds of their ranges could still be acceptable.

In any case, the current ranges represent a way station on the road to reasonable price stability. Even with a return to the traditional secular stability of M2 velocity, the midpoint of the current ranges would still be higher than needed to support long-run economic growth in the context of price stability. And, if velocity

increases do in fact occur during a transition period to a higher long-run equilibrium level, then ranges somewhat lower than the current specifications would be warranted over this interval. But in light of the considerable uncertainties about nearer-term velocity developments, the Federal Open Market Committee did not commit itself to new, respecified ranges for M2 or M3 for 1992. Such a respecification would carry the presumption that the new range was clearly more consistent with broader economic objectives, and in view of the uncertain relationships involved, the FOMC did not wish to convey that impression. This year's ranges were carried forward on a provisional basis for 1993, until such time as additional experience and analysis could be brought to bear on the issue of monetary behavior. In any event, the FOMC will revisit the issue of its money and credit ranges for 1993 no later than its meeting next February. By then more evidence will have accumulated about evolving monetary relationships. In light of the difficulties predicting velocity, signals conveyed by monetary data will have to continue to be interpreted together with other sources of information about economic developments.

Concluding remarks

I expect that the economic expansion will soon gain momentum, which lower inflation should help to maintain. Although the economy still is working its way through structural impediments to more vigorous activity, the advances that already have been made in this regard augur well for the future. Banks and other lenders, having made considerable strides in rebuilding capital, have greater capacity to meet enlarged credit demands. The strengthening of household finances to date has established a firmer foundation for future

consumer outlays. And the restructuring of business balance sheets so far, together with improved labor productivity and profitability, has better positioned producers to support sustainable output gains. These gains would be even larger if the federal government can make significant progress toward bringing the budget into balance, releasing saving for productive private investment, and brightening further the prospects for ongoing advances in living standards for all Americans.

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